



THE WORLD BANK

# Report on the Observance of Standards and Codes (ROSC)

Corporate Governance

## Corporate Governance Country Assessment

Bosnia and Herzegovina  
June 2006

# Overview of the Corporate Governance ROSC Program

## WHAT IS CORPORATE GOVERNANCE?

Corporate governance refers to the structures and processes for the direction and control of companies. Corporate governance concerns the relationships among the management, Board of Directors, controlling shareholders, minority shareholders and other stakeholders. Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital.

The *OECD Principles of Corporate Governance* provide the framework for the work of the World Bank Group in this area, identifying the key practical issues: the rights and equitable treatment of shareholders and other financial stakeholders, the role of non-financial stakeholders, disclosure and transparency, and the responsibilities of the Board of Directors.

## WHY IS CORPORATE GOVERNANCE IMPORTANT?

For emerging market countries, improving corporate governance can serve a number of important public policy objectives. Good corporate governance reduces emerging market vulnerability to financial crises, reinforces property rights, reduces transaction costs and the cost of capital, and leads to capital market development. Weak corporate governance frameworks reduce investor confidence, and can discourage outside investment. Also, as pension funds continue to invest more in equity markets, good corporate governance is crucial for preserving retirement savings. Over the past several years, the importance of corporate governance has been highlighted by an increasing body of academic research.

Studies have shown that good corporate governance practices have led to significant increases in economic value added (EVA) of firms, higher productivity, and lower risk of systemic financial failures for countries.

## THE CORPORATE GOVERNANCE ROSC ASSESSMENTS

Corporate governance has been adopted as one of twelve core best-practice standards by the international financial community. The World Bank is the assessor for the application of the OECD Principles of Corporate Governance. Its assessments are part of the World Bank and International Monetary Fund (IMF) program on Reports on the Observance of Standards and Codes (ROSC).

The goal of the ROSC initiative is to identify weaknesses that may contribute to a country's economic and financial vulnerability. Each Corporate Governance ROSC assessment reviews the legal and regulatory framework, as well as practices and compliance of listed firms, and assesses the framework relative to an internationally accepted benchmark.

- Corporate governance frameworks are benchmarked against the OECD Principles of Corporate Governance.
- Country participation in the assessment process, and the publication of the final report, are voluntary.
- The assessments focus on the corporate governance of companies listed on stock exchanges. At the request of policymakers, the ROSCs can also include special policy focuses on specific sectors (for example, banks, other financial institutions, or state-owned enterprises).
- The assessments are standardized and systematic, and include policy recommendations. In response, many countries have initiated legal, regulatory and institutional corporate governance reforms.
- Assessments can be updated to measure progress over time.

By the end of June 2005, 48 assessments had been completed in 40 countries around the world.

# REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)

## Corporate governance country assessment

### Bosnia and Herzegovina

June 2006

#### Executive Summary

This report assesses Bosnia and Herzegovina's (BiH) corporate governance policy framework and enforcement and compliance practices. It highlights recent improvements in corporate governance regulations, makes policy recommendations, and provides investors with a benchmark against which to measure corporate governance in BiH.

Since the 1995 Dayton Agreement, BiH's two *entities*, the Federation of Bosnia and Herzegovina (FBiH) and the Republic Srpska (RS), have each put in place the basic legal and institutional framework for functioning capital markets. Privatization has created hundreds of companies available for trading on two stock exchanges. Recent reform includes laws to improve the governance of state-owned companies, the creation of a new state commission for accounting and auditing, the development of a common electronic platform for local business registers, the drafting of new securities laws and laws on investment funds, and the recent decision in each entity to publicly disclose the top ten owners of each publicly traded company.

However, challenges remain. The two regimes have a number of basic weaknesses: investors have insufficient redress; key information for many companies is not available or is of poor quality, the duties of board members are unclear, and their liabilities limited. The securities commissions in each entity have limited authority and resources to oversee the large number of issuers. There is no corporate governance code and awareness of corporate governance is limited. There are also significant differences between the corporate governance regimes of each entity, which can be a source of additional cost and confusion for both foreign and domestic market participants.

Improving corporate governance to better protect investors, enhance company oversight, and increase confidence in capital markets will require broad-based reform. Recent reforms should be fully implemented, and the law on enterprises in each entity fundamentally revised and harmonized with each other and with EU requirements. These efforts should be combined with training and other programs to raise awareness of corporate governance across BiH each including the development of a Code of Corporate Governance. The authority of securities commission should be enhanced, and (as with banking and auditing regulation) consideration should ultimately be given to moving securities regulation to the state level.

## **Acknowledgements**

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The assessment reflects technical discussions with the Federation of Bosnia and Herzegovina Securities Commission, the Republic Srpska Securities Commission, the Sarajevo Stock Exchange, the Banja Luka Stock Exchange, the Registry of Securities of the Federation of Bosnia and Herzegovina, the Central Registry of Securities of the Republic of Srpska, Agency for Privatization in Federation of Bosnia and Herzegovina, Republic of Srpska Directorate for Privatization, the Office of the High Representative, the IFC PEP-SE project, legal experts, commercial banks, issuers, and numerous market participants.

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## Country assessment: Bosnia and Herzegovina

This ROSC assessment of corporate governance in Bosnia and Herzegovina (BiH) benchmarks law and practice against the OECD Principles of Corporate Governance (Principles), and focuses on publicly traded companies<sup>1</sup>. Related recommendations are presented in the BiH Accounting and Auditing ROSC (2004).<sup>2</sup>

Bosnia and Herzegovina (BiH) is divided into two entities—the Federation of Bosnia Herzegovina (FBiH) and the Republic Srpska (RS)—plus the autonomous Brcko District<sup>3</sup>. The FBiH is in turn divided into ten cantons. Under the 1995 Dayton Peace Agreement, the Bosniak/Croat FBiH and the Serb RS each has its own laws and institutions, with limited authority reserved for the central state. Corporate governance comes under the authority of the entities, and BiH has two distinct corporate governance regimes.

The process of privatization in each entity has led to hundreds of publicly traded companies and made hundreds of thousands of citizens shareholders. However privatization is not yet complete, and many companies, including most large companies, retain significant state ownership. The legal framework in each entity has largely been developed since 1998, with frequent amendments, and significant guidance from the donor community. Overall, while many elements of a fully functioning capital market are in place, awareness of corporate governance is limited and important legal and institutional gaps remain.

### Market profile

*The war and subsequent dislocation has resulted in a corporate landscape with relatively few large-scale enterprises*

Before the war, BiH's economy was dominated by large state owned enterprises (SOEs) that covered all of the former Yugoslavia. The war brought a collapse of intra-Yugoslav trade, substantial physical damage to production facilities, and the division of many large enterprises along Bosniak, Croat, and Serb lines. As a result, BiH has fewer large scale enterprises, especially private enterprises, than other countries in South East Europe.

*Started in 2002, activity on the stock exchange in each entity has been growing rapidly*

Each entity has a stock exchange, the Sarajevo Stock Exchange (SASE) in FBiH and the Banja Luka Stock Exchange (BLSE) in RS. Both began operating in 2002. Over the last two years each exchange has experienced significant increases in the number of traded companies, turnover, market capitalization, and the main market indexes.

*The two exchanges have over 1400 companies; almost all are quoted on their respective "Free Market" and do not meet formal listing*

At the end of 2005, 1579 companies were available for trading on the two exchanges, including 24 Privatization Investment Funds (PIFs); the PIFs and 3 additional companies in RS are listed on the "Official Market".<sup>4</sup> Companies on an Official Market must meet certain listing requirements—though PIFs are required to be listed. All other companies are traded on the "Free Market" of their respective exchange. A company is automatically registered on the Free Market when a broker receives an order to buy or sell that company's shares, and the

<sup>1</sup> This includes practically all joint stock companies (JSCs), whose shares must be traded through the two stock exchanges.

<sup>2</sup> Available at <http://www.worldbank.org/ifa/BosniaHerzegovinaA&A.pdf>

<sup>3</sup> This report will focus on the FBiH, RS, and the BiH as a whole. It will not explicitly address the relatively small Brcko district. While Brcko does have its own securities commission, joint stock companies in Brcko list can be traded in either entity, and tend to adopt the practices of the entity where they are traded.

<sup>4</sup> This includes 774 companies (including 11 PIFs) on the SASE, and 805 companies (including 13 PIFs) on the BLSE.

*requirements*

issue is recorded at the entity's Central Registry of Shareholders. While mergers and conversion to non-traded limited liability companies led to a small number of delistings in each market, the total number of companies available for trading has increased significantly over the last few years. On a typical day the shares of 45 to 55 companies are traded on the SASE, 35-45 on the BLSE. Trading tends to be concentrated: five companies on the BLSE accounted for 44% of trading in 2004. The PIFs are among the most actively traded companies on each stock exchange, and generally trade on a daily basis: on the SASE, the ten PIFs accounted for 33% of the turnover in 2005, the 13 on the BLSE 25%. The shares of many other companies are traded only a few times a year, or less.

*While privatization is ongoing, state ownership remains extensive*

The legacy of state ownership is strong. All traded companies are fully or partly privatized state owned enterprises (SOEs) or PIFs established to hold the shares of privatized companies. In addition, the State retains an estimated 40% of the equity of joint stock companies and State capital is held at the entity level in RS and the entity and cantonal level in FBiH and remains substantial, with state shares as high as 90% in publicly traded companies in FBiH and 65% in RS. The entities and cantons retain ownership and control in a range of companies, including not only the big utilities like electricity and telecoms, but also companies involved in manufacturing, mining, forestry, and transportation.

*Privatization has created hundreds of thousands of shareholders, but control is concentrated*

Privatization has been carried out through employee buyouts, vouchers distributed to all adults in each entity, and tenders of significant stakes. There are an estimated 532,000 shareholders in FBiH and over a million shareholder accounts in RS, out of a total population of approximately 3.8 million, who hold shares directly in companies and in PIFs. Practically all companies have some small shareholders, including employees. Some large companies have thousands of shareholders, and PIFs can have tens of thousands. While ownership data is limited, it is estimated that the PIFs and the RS Pension Fund have stakes of 10% or more in more than half of large companies.

Significant and controlling shareholders hold large positions in most companies and include company management, entrepreneurs who bought a large stake of the company during privatization, or the entity or canton. The entity or canton's ownership rights are exercised by a minister or other member of government. In RS, PIFs are controlling shareholders in some companies.

*Foreign ownership is growing*

According to market participants, foreign investment is growing. Most banks now have a foreign controlling shareholder, as do some other traded companies, including a PIF management company. Portfolio investment from Slovenia and other countries is also a growing force on each exchange. There are no legal limits on foreign ownership in BiH, although the small size of each market may limit investment by international institutional investors.

*Each entity has its own laws and regulators*

Each entity has a distinct Law on Enterprises (LE), Law on Securities (LS), implementing regulations, and each has its own Securities Commission (SC) that is responsible for regulating capital markets and protecting investors. The differences between the LEs are particularly significant, including different board structures and key differences in shareholder powers and redress, and can be source of confusion amongst market participants. Each entity uses a "triple registry" system for companies, with founding documents filed at a local court register, share ownership recorded in an entity-wide Central Registry of Securities (CRS), and issuers tracked in an entity wide Register of Issuers maintained by the SCs.

*Some laws are*

Some elements of the legal framework are "harmonized", with similar provisions

*harmonized across the entities, and the regime for accounting and auditing will move up to the state level*

across the two entities. This includes the Laws on Public Enterprises (LPE)—which govern SOEs — the Laws on Banking, and the Laws on Insolvency. In 2005 the entities passed new Laws on Accounting and Auditing that will allow for a single regime across BiH and place accounting and auditing standards, testing and oversight under the authority of a single state-level commission. A state-level electronic platform for the local court registers is also being introduced. As an aspirant for membership in the European Union (EU), harmonization and moving functions to the state level are likely to continue to achieve compliance with the *Acquis Communautaire*.

## Key issues

The following sections highlight the principle-by-principle assessment of Bosnia and Herzegovina's compliance with the OECD Principles of Corporate Governance.

### Investor protection

*Shareholders and companies have limited awareness of their rights and obligations*

Each entity has established its own framework for investor protection, with important differences in law and regulations. In each entity, shareholders and shareholder-owned companies have largely been created by privatization, and the relevant institutions and laws have only come into force over the last few years. As a result, both shareholders and issuers have a limited awareness of their rights and obligations.

*Basic shareholders rights are in place in each entity*

Shareholders in each entity can and do participate in the general meeting of shareholders (GMS). They have standard powers to place items on the agenda of the GMS, and through the GMS approve changes to the company's statutes, authorize dividends, approve capital increases to authorized capital and mergers, and appoint the company's auditor. Under the law, shareholders may also call exceptional meetings, inspect certain company documents, call for a special audit of the company, and approve remuneration for board members. Shareholders also have preemptive rights during capital increases. However these can be waived by the GMS. The exact procedures to exercise these rights differ between the two entities.

*Small shareholders can participate in the general meeting and have voting power proportional to their ownership...*

Shareholders in each entity participate both directly in GMS and through proxies or in some cases by mail. Some companies have shareholder associations that pool the votes of small shareholders. The voting power of shareholders is generally proportional to their ownership; the great majority of shareholders have ordinary, single vote, shares. Multiple-voting shares are not allowed, and the use of preferred shares is limited. Pyramid structures and similar mechanisms designed to allow for disproportionate control are not widely used. Company law in each entity also explicitly acknowledges the equal rights of shareholders in the GMS.

*...however certain legal provisions and omissions may prevent participation on a full and equal basis*

However non-controlling shareholders face certain barriers to full participation in the GMS. There are no rules on the timing of the meeting in RS and those in FBiH are unclear, which allows for significant variability and delay. Agendas are often adhered to rigidly, with little or no opportunity for general questions. The rules for cumulative voting in FBiH are not well understood and, while mandatory, not always followed. Quorum requirements have been lowered in response to problems in holding the GMS at PIFs, which have large numbers of shareholders.



*The entities have modern share registration, however problems with identity theft have been reported*

Other problems for shareholders include potentially insecure share registration and the regime for related party transactions. Shares in each entity are fully dematerialized and the two Central Registry of Securities (CRS) competent and equipped with modern technology. However in FBiH, the SC has noted that “identity theft” through forging identification documents has reportedly been used to steal shares from some accounts and considers it an ongoing problem.

*Related party transactions are rarely disclosed*

In each entity, related party transactions are supposed to be disclosed by the company in financial statements, but compliance is poor. Neither entity requires shareholder approval or explicit board approval of such transactions. Each entity has different rules for major transactions, and shareholder approval of large transactions is only required in FBiH. In each entity, interested parties are required to recuse themselves from voting in the GMS. Under the current regime, there is a real possibility of abusive transactions. However, market participants have reported a limited number of potentially abusive transactions.

*A critical issue in BiH will be facilitating ownership consolidation while protecting minority shareholders*

If experience in other transition economies is any guide, many publicly traded companies will ultimately leave the two exchanges as controlling shareholders increase their positions. In BiH this process has begun as ownership consolidates and publicly traded joint stock companies (JSC) convert to non-traded limited-liability companies.

To protect small shareholders, each entity has a mandatory bid rule where shareholders with at least 30% (FBiH) or 25% (RS) of a company’s shares must make an offer to the other shareholders. This has led to some ownership consolidation, though in a number of cases too few shareholders have accepted the offer for it to be binding. Each entity has different rules for conversion to a limited liability company, and there have been complaints that some conversions have not allowed small shareholders to exit. Neither entity has squeeze-out or sell-out rules that compel either controlling shareholders to buy or minority shareholders to sell when a high ownership threshold—e.g. 90%—is reached

*PIFs play a large role in capital markets and are closely regulated...*

PIFs participate in shareholder meetings, influence the choice of board members, and in the process represent hundreds of thousands of shareholders. Some concern has been expressed that PIFs are not active enough in pushing companies to restructure, but this may not be surprising given their large portfolios, or the generally passive nature of funds in other countries. PIFs in the RS are allowed to take controlling stakes in companies, FBiH PIFs are not.

*...however PIFs have minimal requirements regarding conflicts of interest and their corporate governance policies*

While closely regulated by the SCs, PIFs are not required and do not disclose or develop policies on voting or other corporate governance related issues, and legal provisions regarding conflicts of interest may be inadequate given their large role in capital markets. Under the law in each entity, PIFs have begun to convert to other kinds of funds, and changes are being prepared to the relevant legislation to support this transition<sup>5</sup>.

## Disclosure

*Companies produce basic financial statements, other*

Each entity has a number of corporate reporting requirements under various laws and regulations. In practice companies do produce basic financial statements. Other forms of reporting tend to be minimal. Omissions in annual reporting

<sup>5</sup> In FBiH, the PIFs have recently converted to closed-end investment funds, new laws under consideration may allow for other types of funds.

*reporting is minimal*

include company objectives, foreseeable risk factors, stakeholder issues, and governance structures and policies. Few companies produce annual reports consistent with international good practice.

*Ownership disclosure is limited*

In each entity, while companies are required to disclose significant shareholders and ownership by board members and management, ownership remains opaque. Only direct ownership is reported, and compliance is far from perfect. While law refers to “indirect ownership”, this is not defined and not used in practice. There is also no easily accessible or widely disseminated record of cantonal or entity ownership. The recent decisions of the two CRSs to list the top ten owners of each company should significantly improve corporate transparency.

*Standards for accounting and auditing standards were outdated and divergent, and implementation was limited*

Until recently, each entity had its own regime for accounting and auditing. Accounting standards were based on outdated translations of International Financial Reporting Standards (IFRS), with important differences in interpretation between the two entities. Audit standards were based on old translations of International Audit Standards (IAS). Implementation was limited and auditor oversight poor. In practice, only companies with foreign owners or investment produced financial reports based on international standards of accounting and auditing.

*A new state-level commission should improve standards and oversight*

A state-level Framework Accounting and Auditing Law (FAA) was passed in 2004, and enabling legislation passed in each entity more recently. This creates a new state-level Independent Standards Commission (ISC) and requires full IFRS and ISA compliance for all companies in BiH with revenue of one million convertible marks (KM) or greater or 50 or more employees. This legislation has yet to be fully implemented at the time of this assessment. Full implementation will be a challenge for some companies and for the many auditors that are not connected to the “big four” international network firms and have limited experience with international standards.

*Company information is fragmented and must be accessed from a variety of sources*

Shareholders can access data from a variety of sources, but information is fragmented and can be incomplete. Basic company documents can be inspected at the local court register, but cannot be accessed online or through other means. Full financial statements are available from specialized agencies<sup>6</sup>. Shareholders can request information directly from the JSC at their own expense. Many required reports are published in daily newspapers. The SASE website includes PIF financial reports, the BLSE semiannual financial statements and data on ownership structure. The FBiH Securities Commission web-site includes annual financial statements of all PIFs and a number of JSCs. A “webportal” is planned in the RS that will include annual statements and the top ten owners of each company.

### **Company oversight and the board**

*Companies in BiH have a variety of board structures*

Companies in BiH have a number of different board structures. Companies in FBiH have a single “supervisory” board of non-executives. Companies in RS have both a supervisory board and a management board, though RS companies with fewer than 100 shareholders can choose not to have boards. RS companies may also have an optional committee of executives distinct from the management board. SOEs which fall under the Law on Public Enterprises in each entity have a supervisory board and a management board, but the management board is chosen

<sup>6</sup> “FIPA” in FBiH and “AFIP” in RS, these are the descendents of the old centralized payment system.

*Most companies in BiH have an “audit board”, few have specialized board committees*

by the supervisory board, not directly elected by shareholders as in (other) RS companies. As in FBiH, banks in each entity have a single supervisory board. The net effect is multiple board structures in each entity, company organs with the same name that perform different functions, and limited understanding by market participants of legal requirements for and powers of boards.

Companies in FBiH, and SOEs and banks in each entity have an “audit board” whose members do not serve on other boards. Audit board members are elected directly by the GMS, or in the case of some SOEs, chosen by each entity’s supreme public sector auditor. Other companies in RS do not have audit boards. Few companies have audit committees or other specialized committees made up of supervisory or management board members, with the exception of the RS executive committee.

*The FBiH supervisory board and the RS management board serve similar functions*

In practice, FBiH and bank supervisory boards (which meet jointly with management) and RS management boards (which include non-executives and are directly elected by shareholders) perform many of the same functions. In turn the RS supervisory board and FBiH and bank audit board play a similar, and limited, oversight role.

*The limited duties and liabilities of board members are not effectively implemented*

Board members in each entity have limited and unclear duties and limited liabilities. The LE in FBiH requires supervisory board members to act in the interest of shareholders and the company. In the RS, management board members are to act in the interest of the company. Board members in each entity can be found liable for negligence and in some other specified cases. While the Corporate Governance Standards in FBiH provide some additional guidance, these provisions seem to have few practical implications. Shareholders in FBiH cannot bring suits against directors; RS shareholders with 10% or more of shares can under certain circumstances. In any case suits in either entity against board members by the company or shareholders are rare.

*Supervisory board members cannot be executives, but there are no independence requirements*

There is no definition of or requirements for “independent” board members in BiH. Management may not serve on the supervisory board in FBiH or RS, and if a RS company has an executive committee, its members are limited to one third of the management board. SOE board members may not be civil servants, members of government or parliament. In practice many companies also have board members that are considered “minority representatives”. There is also no local training for board members that would enhance the skills or perspectives needed for independent judgment.

*SOE oversight has been strengthened*

The 2004 LPEs require an open process for choosing members of the SOE supervisory board and gives the audit board greater powers, including oversight of an independent internal auditor. SOEs have been corporatized and separated from the public administration. State-owned utilities now have independent regulators. These and other recent reforms address concerns about inefficiency and political interference in SOEs. However governments and political parties still exercise significant direct influence through the ministers or others who vote state capital in the GMS, and SOEs continue to have non-commercial objectives that are often not explicit or consistent through time.

## Enforcement

*While shareholders have certain opportunities for*

Shareholders in each entity can, under certain circumstances, call an extraordinary GMS, request the company be audited, and challenge the decisions of the GMS. Shareholders in FBiH can demand the company buy back their shares if they dissent on certain decisions; and shareholders in RS can bring suits against

<i>private redress...</i>	directors.
<i>... there effectiveness is limited</i>	However restrictive and divergent legal provisions, the limited specialization of the court system, and the costs and delays of going to court to enforce these actions under the law have limited the impact of these shareholder powers.
<i>The SCs are active, but have limited authority over issuers</i>	Each SC actively polices brokers and the PIFs. Their authority over issuers is more restricted. The SCs cannot levy fines or bring cases directly against companies, which is the responsibility of local prosecutors. They also have limited resources, and would have difficulty in providing more oversight for BiH's large number of publicly listed companies.  There are few other sources of redress. The stock markets only have a basic surveillance function, and no other entity or state level regulator (except the SCs) has authority over capital markets or a mandate to protect shareholders.
<i>There is no state level code of corporate governance</i>	The SC in each entity has recently issued a new code of corporate governance ("Rules on the Governance of Joint Stock Companies" in FBiH and "The Standards of Corporate Governance" in RS). While each code is primarily voluntary, both SCs require a statement on compliance or noncompliance with the relevant code, and the RS code contains certain provisions—coinciding with the LE and other existing laws and regulations—that are mandatory for companies listed on the official market. The two codes contain distinct provisions and are not harmonized with each other. Neither code has been fully implemented at the time of this report, nor have no compliance statements been issued by companies.

## Recommendations

<i>The reform process should continue</i>	Since the Dayton Agreement, Bosnia and Herzegovina (BiH) has undergone significant and broad based reform, introducing the legal and institutional framework for capital markets and corporate governance, much of it in the last few years. However, fully tapping the potential of capital markets and professionalizing boards and management will require that reform continues. Good corporate governance ensures that companies use their resources more efficiently and leads to better relations with workers, creditors, and other stakeholders. It is an important prerequisite for attracting the patient capital needed for sustained long-term economic growth. For BiH, reform to corporate governance and disclosure will also be an important part of preparation to join the European Union.
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### ***Broad based corporate governance reform is needed...***

<i>Revise the securities law and develop a new company law...</i>	While there has been no shortage of recent legal change, significant reform is still needed. Current plans to upgrade and harmonize the Law on Securities (LS) and Law on Investment Funds in each entity should advance. Critically, a new Law on Enterprises (LE) should be developed. While each entity will pass and implement the new law, it should be developed based on state-wide consultation and the final versions tightly harmonized, with common provisions, common terminology and similarity at a high level of detail.
<i>...in light of the OECD Principles, EU requirements, and practices in neighboring countries</i>	The revisions to LS and Law on Investment Funds and the new LE should seek to provide better protection for small shareholders, increase transparency, and improve the performance of the company boards along the lines of the OECD Principles. They should be developed in light of EU requirements, including the relevant provisions of the Transparency Directive, Takeover Directive, and directives on company law. The developing EU Action Plan for Corporate

Governance and draft Shareholder Voting Directive should also be considered. To facilitate this process a comprehensive assessment of BiH's compliance with EU requirements in this area, and the legal changes needed to comply with them, would be useful.

Many of BiH's neighbors and other former Yugoslav countries have already launched broad based company and securities law reform, including Croatia, Macedonia, and Slovenia, to improve corporate sector performance and comply with EU requirements. Experiences in these countries could provide useful lessons for BiH, and adopting common provisions and practices may increase the confidence of the regional investors who are playing a growing role in local capital markets<sup>7</sup>.

*Consider introducing a new company form: "closed" JSCs*

One issue to be considered for the new LE is the introduction of a distinction between "open" JSCs and "closed" JSCs. Such a distinction is used in other countries in the region. Closed JSCs would have a limited number of shareholders, e.g. 100, and would not be required to meet all the disclosure requirements of open JSCs. Overall, they would provide shareholders with certain rights not found in limited liability companies, but face a lower regulatory burden than open JSCs.

One benefit of introducing such a distinction would be lower compliance costs for small companies. Another would be allowing the Securities Commissions (SC) to focus their resources overseeing a smaller number of open JSCs. However, some shareholders may find their shares more difficult to trade and information on their investments limited.

*Strengthen the Securities Commissions*

Revisions to securities law should seek to give each SC greater, and similar, power over issuers. This should include the authority to fine certain issuers directly and suspend or reverse a wider range of decisions. BiH's relatively strong banking supervisors may provide a model. To be effective, greater authority over issuers may require greater resources to be effective.

In the longer term, moving securities regulation to the state level, with a single BiH Securities Commission, should also be considered. Authority over accounting and auditing has been moved to the state level, and a state level banking supervisor has been proposed. Creating a single SC would reduce costly duplication and further harmonize practices in each entity.

*Introduce a Code of Corporate Governance*

A BiH Code of Corporate Governance should be introduced that provides additional guidance beyond existing or new legal requirements and builds on international best practice, including the toolkit from the Global Corporate Governance Forum. The Code should address board issues, conducting the shareholder meeting (GMS), good practice for company secretaries, and other relevant areas. A single, state-wide code should be developed, to be implemented by each stock exchange and SC. A process for evaluating a company's "comply or explain" statements with the Code should be introduced as a legal requirement in each entity (as in the Netherlands).

Policymakers should consider extending the reach of the Code with special chapters for public enterprises, investment funds, and banks. The Central Bank and each banking supervisor should be consulted and the option of making the Code mandatory for all banks should also be considered.

<sup>7</sup> The OECD *White Paper on Corporate Governance in South East Europe*, which was developed with input from BiH and disseminated in each entity, also provides useful guidance in light of the OECD Principles based on the experience of the region.

*Raise awareness of the importance of corporate governance across BiH*

The development of a Code and new LE provides an excellent opportunity to raise awareness of the importance of corporate governance. Each should be developed through consultation with a variety of stakeholders across BiH. The Macedonian Corporate Governance and Company Law Project is a good model ([www.maccorpgov.com](http://www.maccorpgov.com)) of such a consultative process. The newly established International Finance Corporation Private Enterprise Partnership for South East Europe (PEP-SE) will also be providing training and other programs, and could be a critical force to increase corporate governance understanding and encourage companies to improve their corporate governance practices in anticipation of a new code or changes to the law.

***...to better protect small shareholders...***

*Shareholder participation in the GMS should be facilitated*

To allow small shareholders to participate fully in the GMS, the LE should include clearer provisions for when to hold the meeting and explicitly allow shareholders to ask questions of board members. The Code could also provide guidance on conducting the meeting.

*Common provisions on major and related party transactions, changes in share capital, and shareholder redress should be adopted*

To prevent abusive transactions, each entity should adopt common procedures for major transactions and related party transactions. These can include requiring approval by disinterested (and eventually independent) board members, that the audit board or auditor provides an opinion on such transactions, approval by disinterested shareholders of transactions that surpass certain thresholds, and that such transactions be carried out at market reference prices.

Similarly, each entity should adopt common provisions for shareholder redress, including withdrawal rights along the lines of those currently found in F BiH, and common provisions on changes in share capital. The later should provide the GMS with exclusive authority over increases in authorized capital and not allow pre-emptive rights to be waived except in very limited circumstances.

*As should common provisions on control transactions and company conversion*

Legal reform should also harmonize provisions for tenders, control transactions, and conversion from JSC to limited liability company (or to a “closed” JSC if such a concept is introduced in the law). The latter should require SC approval in each entity. They should include a maximum threshold for when a tender is binding, e.g. 51%. Guidance on “acting in concert” and communication between major shareholders, including PIFs and other funds, should be provided. Sell-out rights and squeeze-out rights that allow, or in some cases require, small shareholders to sell at a fair price determined by independent appraisal to a controlling shareholder with 90% or more of shares should also be considered.

*Investment funds should be required to disclose and develop policies on conflicts of interest and voting in the GMS*

Several thousand small shareholders have shares in PIFs, and the governance practices of PIFs and the investment funds that replace them should be addressed as part of any serious corporate governance reform. PIFs and other investment funds should be required to disclose their voting record in the GMS and develop and disclose policies on how their ownership rights will be exercised. Investment funds should also be required to develop policies that address conflicts of interest and disclose potential conflicts. This includes relationships between the owners and managers in the fund management company and the companies the fund invest in as well as between the management company and related financial intermediaries. Restrictions on such relationships should also be considered. The EU “Undertaking for the Collective Investment of Transferable Securities” may provide a useful model.

To facilitate this process, training should be provided to investment fund managers and staff. PIFs should also be encouraged to adopt some of the practices

voluntarily before the law is changed.

**...enhance transparency...**

*Companies should be required to produce annual reports*

To improve corporate transparency a standard annual report format should be developed and introduced in each entity. This format would incorporate the relevant reporting requirements companies have under the law and would require a discussion by the board or management of company objectives, foreseeable risk factors, relevant issues regarding stakeholders, and governance structures and policies. Producing such a report should be obligatory for companies that are traded on the exchanges and now required to comply with international standards of financial reporting and auditing. The Code could also provide more detailed guidance on compiling the report.

*Both direct and indirect ownership should be disclosed*

Increasing the transparency of ownership and control will require changes in the disclosure of both direct and indirect ownership. Registry data should gradually be made open to the public, building on recent decisions to report the ten largest shareholders in each company. Policy makers and the two CRSs should also consider eventually—as is the case in Slovenia—disclosing the entire list of shareholders for each publicly traded companies. Indirect ownership should be defined in the law, and individuals required to disclose significant indirect ownership (as is already required in some cases). The EU Transparency Directive should provide useful guidance on disclosure of indirect ownership. Reform in this area should also include adequate sanctions for failure to disclose.

To better protect registry data and prevent illegal share transfers, the CRSs and SCs should work with other authorities to protect against identity theft. This should include both basic precautions and learning from international best practice.

*The new accounting and auditing laws should be fully implemented*

BiH has developed a new and greatly improved regime for accounting and auditing, however this regime must still be fully implemented. The 2004 Accounting and Auditing ROSC provides additional recommendations to improve transparency and disclosure and should also be taken into account.

*Company information should be available online*

Improved transparency will require improved access to company information. The new electronic court register should be fully accessible online. The planned “webportal” in RS should be rolled out as soon as possible, and may provide a good model for FBiH. In the longer term, “one window” for shareholders in BiH should be developed that contains corporate reports, ownership information, and founding documents for publicly traded companies in both entities.

**...and increase the effectiveness of company oversight**

*Introduce a common board structure for publicly traded companies*

A fundamental objective of the new LE should be a common board structure for all publicly traded companies in BiH, including banks and SOEs. The new law could also allow for certain elements—such as an executive committee or audit board—to be optional or only mandatory for certain companies. Having a common structure does not preclude special requirements for banks or SOEs. The Code can also provide guidance on board structures, including a true audit committee of the board / supervisory board, to assume responsibility for company internal control policies.

*Clarify board member duties and liabilities*

The new LE should have common and clear duties for board members, including a duty to act in the interest in all shareholders and with due care and due diligence. These duties should provide the basis for board member liabilities, and shareholders in each entity should be able to bring suits on behalf of the company

against board members. The Code should elaborate on these duties and provide board's additional guidance.

*Encourage independent members on boards*

Both the LE and Code should address board independence. This should include defining independence, suggesting a certain number or fraction of independent members on supervisory boards, and specifying areas where independent board members should play a leading role.

*Develop board member training*

Developing board member independence and objectivity will require expanded training for board members and companies. PEP-SE can play a valuable role in facilitating the development of domestic board training that can continue into the future. Along these lines, consideration should be given to establishing a domestic institute of corporate governance. The toolkit produced by the GCGF on "Building Director Training Organizations" provides useful guidance in creating such an institute.

*Continue to improve the oversight of companies with state capital*

Each entity should build on the reforms of SOE oversight launched last year, and consider developing ownership policies consistent with the 2005 OECD Guidelines on Corporate Governance of State Owned Enterprises. To facilitate this diagnostic based on the Guidelines should be carried out to address the specific challenges of the state owned sector.



## Summary of Key Recommendations

Recommendation	How to be Introduced	Priority/Status
<b><i>Institution Building</i></b>		
Strengthen the institutional capacity & competence of the Securities Commissions.	Securities Commissions prepare & adopt Institutional Development Plans.	Immediate
Prepare recommendations to improve corporate governance of state-owned enterprises.	Diagnostic of state owned enterprise corporate governance based on OECD Guidelines.	Immediate
Raise awareness of corporate governance.	Corporate governance seminars, discussions, and relevant training (ex. through IFC PEPSE).	Immediate
Give Securities Commissions the authority to levy sanctions and take direct action against issuers (with appeals to courts).	Revisions to Securities and related law.	Medium-Term
Prepare a phased-in program to move securities, and related supervision to state-level regulators.	Review of costs and benefits of program. Possible revisions to Securities and related law.	Long-Term
<b><i>Legislative Framework</i></b>		
Develop a strategy for the introduction of closed companies and other elements of a new Law on Enterprises.	Establish a state-level working group supported by local and international consultants.	Immediate
Introduce a new state-level or tightly harmonized Law on Enterprises based on EU requirements and guidelines.	Through broad based, state-wide consultation with relevant international support.	Medium-Term
Upgrade and harmonize the Law on Securities and Law on Investment Funds.	Through broad based, state-wide consultation with relevant international support.	Medium-Term
<b><i>Boards and Oversight</i></b>		
Introduce a single BiH Code of Corporate Governance covering traded companies, PIFs, state-owned enterprises & banks.	Extensive consultations with private sector including SASE and BLSE, building on current standards.	Immediate
Increase training for management and supervisory board members. Establish a domestic governance institute.	Private initiatives, including those led by IFC PEPSE.	Immediate
Encourage independent members of boards.	Part of Corporate Governance Code.	Immediate
Introduce common board structure for all traded companies, including banks and state-owned enterprises.	New Law on Enterprises, revisions to Law on Public Enterprises, Law on Banks.	Medium-Term
Introduce board member duties in light of practice in EU countries.	New Laws on Enterprises.	Medium-Term
<b><i>Transparency and Disclosure</i></b>		
Fully implement the new regime for accounting and auditing.	Based on current efforts.	Immediate
Introduce a standard annual report format.	New regulation based on current efforts.	Immediate
Improve direct disclosure through central registries.	Initiative by securities registrars based on current efforts. Revisions to Securities and related laws.	Immediate
Require disclosure of significant indirect ownership in line with EU Transparency Directive.	Revisions to Securities and related laws.	Medium-Term
Improve access to company information, including online court register & web portals.	Based on current efforts. Develop integrated interface covering both SASE & BLSE.	Medium-Term
Introduce "one window" for company information.	State and entity-level legal changes and the commissions, central registries, and stock exchanges.	Long-Term
<b><i>Investor Protection</i></b>		
Adopt common and improved procedures for major and related party transactions, shareholder redress & changes in share capital.	New Laws on Enterprises.	Medium-Term
Adopt common provisions for tenders, control transactions, and company conversion.	Revisions to Securities and related laws. Harmonized Law on Takeovers.	Medium-Term
Facilitate shareholder participation in shareholders' meetings.	New Laws on Enterprises with additional guidance from the Code.	Medium-Term
Consider "mandatory tender offer" and "squeeze-out" rights.	Revisions to Securities and related laws.	Long-Term
Require investment funds to disclose and develop policies on ownership and conflicts of interest.	Revisions to Securities and related laws based on current efforts with additional training and support.	Long-Term

## Summary of Observance of OECD Corporate Governance Principles

Principle	O	LO	PO	MO	NO	Comment
<b>I. ENSURING THE BASIS FOR AN EFFECTIVE CORPORATE GOVERNANCE FRAMEWORK</b>						
IA Overall corporate governance framework			X			• Privatization is driving capital market development
IB Legal framework enforceable /transparent			X			• Each entity has its own laws and institutions
IC Clear division of regulatory responsibilities			X			• BiH has a number of financial regulators
ID Regulatory authority, integrity, resources			X			• The SCs have limited authority
<b>II. THE RIGHTS OF SHAREHOLDERS AND KEY OWNERSHIP FUNCTIONS</b>						
IIA Basic shareholder rights		X				• Basic rights are in place
IIB Rights to part. in fundamental decisions				X		• No provisions for related party transactions
IIC Shareholders GMS rights		X				• Proxy voting is well established
IID Disproportionate control disclosure			X			• Disclosure of control limited
IIE Control arrangements allowed to function			X			• Mandatory bid often not binding
IIF Exercise of ownership rights facilitated			X			• PIFs do not disclose voting in GMS
IIG Shareholders allowed to consult each other			X			• Little guidance on "acting in concert"
<b>III. EQUITABLE TREATMENT OF SHAREHOLDERS</b>						
IIIA All shareholders should be treated equally			X			• Shareholder redress limited
IIIB Prohibit insider trading			X			• No corporate insiders punished for abusing information
IIIC Board/Mgrs. disclose interests				X		• Existing rules not enforced
<b>IV. ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE</b>						
IVA Legal rights of stakeholders respected			X			• Awareness of stakeholder issues limited
IVB Stakeholder redress		X				• Mediation being developed
IVC Performance-enhancing mechanisms			X			• Performance based pay limited
IVD Stakeholder disclosure				X		• Little reporting on economic prospects or risk factors
IVE "Whistleblower" protection				X		• No explicit protection
IVF Creditor rights law and enforcement		X				• New insolvency laws seem to be working
<b>V. DISCLOSURE AND TRANSPARENCY</b>						
VA Disclosure standards				X		• Most JSCs only provide basic financial statements
VB Standards of accounting & audit			X			• Requirements for IFRS reporting not fully implemented
VC Independent audit annually			X			• New audit standards not fully implemented
VD External auditors should be accountable			X			• Auditor oversight limited, new regime not fully in place
VE Fair & timely dissemination			X			• Company information dispersed
VF Research conflicts of interests			X			• Limited rules on broker conflicts of interest
<b>VI. RESPONSIBILITIES OF THE BOARD</b>						
VIA Acts with due diligence, care				X		• Many board structures, limited and unclear duties
VIB Treat all shareholders fairly			X			• Boards dominated by controlling shareholders
VIC Apply high ethical standards			X			• Awareness limited
VID The board should fulfill certain key functions			X			• Key powers not enumerated
VIE Exercise objective judgment			X			• No requirements for independent board members
VIF Access to information			X			• Board members can generally access information

## Principle - By - Principle Review of Corporate Governance

This section assesses Bosnia and Herzegovina's compliance with each of the OECD Principles of Corporate Governance. **Observed** means that all essential criteria are met without significant deficiencies. **Largely observed** means only minor shortcomings are observed, which do not raise questions about the authorities' ability and intent to achieve full observance in the short term. **Partially observed** means that while the legal and regulatory framework complies with the Principle, practices and enforcement diverge. **Materially not observed** means that, despite progress, shortcomings are sufficient to raise doubts about the authorities' ability to achieve observance. **Not observed** means no substantive progress toward observance has been achieved.

### SECTION I: ENSURING THE BASIS FOR AN EFFECTIVE CORPORATE GOVERNANCE FRAMEWORK

The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

**Principle IA: The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets.**

**Assessment: Partially observed**

**Capital markets.** Market capitalization on the Sarajevo Stock Exchange (SASE) at the end of 2005 was KM 6.3 billion, or US\$ 3.9 billion, a 50% increase since the end of 2004. On the Banja Luka Stock Exchange (BLSE) it was ~KM 2.8 billion, or US\$1.7 billion, a 76% increase over the previous year. These large increases reflected both higher valuations, but also the fact that many new companies have become available for trading as they were corporatized / privatized and their shares were recorded in the Central Registries. For Bosnia and Herzegovina (BiH) as a whole, market capitalization at the end of 2005 was ~ 66% of GDP. This is high for the region and depends in part on calculations of market capitalization by the exchanges that include practically all joint stock companies (JSC), low estimates of BiH's GDP due to the large grey economy, the conversion of a large number of privatized enterprises to publicly traded joint stock companies (JSC), and the inclusion of Privatization Investment Funds (PIF), which hold shares in other JSCs. Turnover on each exchange also increased rapidly in 2005 to US\$350 million on the SASE and US\$114million on the BLSE. However the turnover ratios for the two exchanges, 9 percent on SASE and 6 percent on BLSE, are low by regional or international standards.

The shares of practically all JSCs are tradable on the two exchanges. On SASE, shares of 452 companies have been traded at least once, around 136 companies are traded each month, and about 50 are traded on a regular basis. On the BLSE 466 companies have been traded at least once, and about 30 are traded on a regular basis. While privatization has driven the number of companies available for trading in each entity higher each year, JSCs do leave the exchange as they convert to privately traded limited liability companies or liquidated under the bankruptcy law.

**Ownership framework.** As in most transition countries, the ownership framework in BiH is driven by past privatization programs. Privatization programs in each entity have used a variety of methods, including employee buy outs, vouchers, and tenders. As a result, companies have a variety of owners, and no dominant pattern of ownership has emerged, though most companies do seem to have at least one major shareholder. For example, of companies traded on the BLSE the average company has one or two large shareholders who between them directly own 49% of the company.

Today there are four main groups of owners. First, privatization is far from complete, and state ownership remains extensive. Approximately 40% of equity remains in entity or cantonal ownership, and dozens of companies traded on the two exchanges—including the largest and most heavily traded—have some state ownership. In the RS, the public pension fund and restitution fund also hold 10% and 5% percent respectively of a number of companies traded on the BLSE. The state share of a publicly traded company can be up to 90% in FBiH and 65% in RS.

Second, hundreds of thousands of small shareholders acquired shares during voucher privatization; employees often used their vouchers to buy shares in the company where they worked (or used to work) and some acquired shares before the war. As in other countries with a tradition of social ownership (in the former Yugoslavia) this situation has resulted in company managers having significant control over some companies. However, because of the war and resulting dislocations, long-term managers appear to play a smaller role than in other former Yugoslav countries.

Third, the Privatization Investment Funds (PIFs) hold significant stakes in many companies.

Fourth, foreign strategic and portfolio investors are playing a growing role, especially in banks. Foreign institutional investors have started to invest small amounts on each exchange. At least one JSC is controlled by a foreign fund.

**Institutional Investors.** There are no traditional institutional investors operating in FBiH. Existing institutional investors were created as part of past privatization programs. FBiH has 10 Privatization Investment Funds (PIF) and RS 13. Each PIF has several thousand shareholders and investments in dozens of companies. Each PIF is a joint stock company (JSC) managed by a PIF management company (which may be another JSC). Foreign investment funds (particularly those from Slovenia) have recently begun operating in Bosnia.

**Principle IB. The legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable.**

**Assessment: Partially Observed**

The regulation of capital markets and corporate governance falls under the authority of the entities. While attempts have been made to harmonize certain laws, interpretation and implementation can still differ. Market participants have noted the difficulties of working under two distinct legal regimes.

**Corporate legal framework.** Each entity has its own Law on Enterprises (LE) that set the basic rules for governance of partnerships and companies.<sup>8</sup> There are significant differences between the two laws, including different board structures for JSCs and different mechanisms for shareholder redress. The FBiH LE was amended in 2000, 2002 and 2003; the RS LE in 2002, 2003, and 2004. Each entity passed a Law on Public Enterprises (LPE) in 2004 that is applicable to JSCs with significant state capital. The two LPEs are harmonized and have significant implications for corporate governance, including a distinct board structure and special audit requirements.

**Company types.** The LE in each entity covers four types of enterprise: unlimited partnership, limited partnership, joint stock company (JSC), and limited liability company. The RS LE also provides special rules for a one-owner JSC. Only JSCs may issue shares to the public and have a minimum equity of KM 50,000.00 (EUR 25,564.59) in FBiH and KM 50,000.00 or KM 10,000 in RS, depending on the method of founding. At the end of 2005, 816 JSCs were registered in the RS Central Registry of Securities (CRS) and 709 in the FBiH CRS.

**Securities law framework.** Each entity has a Law on Securities (LS) that governs the issue and trading of securities, the responsibilities of security market participants, and authorizes the SC to oversee capital markets. Revisions to the LS are being prepared in each entity, in part to better harmonize the two laws. The LS in each entity is supplemented by regulations issued by the respective SC. Each SC has authority over issuers and intermediaries, including brokers and PIFs.

**Listing rules.** In both FBiH and RS all trading in the shares of JSCs must go through the relevant exchange<sup>9</sup>. The Sarajevo Stock Exchange (SASE) has an Official Market for companies that meet listing requirements and agree to list a Free Market, on which the shares of unlisted JSCs can trade. Listing for PIFs is mandatory and they are the only listed JSCs in Sarajevo. Listing in Sarajevo requires three documented years of operation, a minimum capital of KM 4,000,000, a minimum share issue of KM 2,000,000, at least 150 shareholders, and approval of the exchanges listing committee.

In Banja Luka, PIFs have their own segment, there are three companies listed on the Official Market, and the rest are traded on the Free Market. Listing requirements in Banja Luka are similar to the SASE, with a minimum capital of KM 5,000,000, shares issued of KM 1,000,000 and at least 50 shareholders. The rules of each exchange require listed companies to make annual and semi-annual reports and immediately report material events.

**Banking Law.** Banking law in the two entities has been harmonized, and proscribes the same board structure for all banks in BiH, qualifications for board members, as well as some other elements of bank governance. Each entity has its own banking supervisor; however there are plans to move supervision to the state level.

**Codes.** The SC in each entity has recently issued a new code of corporate governance (Code)—“Rules on the Governance of Joint Stock Companies” in FBiH and “The Standards of Corporate Governance” in RS. The FBiH Code replaces earlier standards. Each code addresses the GMS, disclosure, Supervisory Board member duties, conflicts of interest involving Supervisory Board members, and risk management and internal controls. The RS Code also addresses stakeholder relations.

Each SC requires a statement of compliance with the relevant code, and the RS code contains certain provisions—coinciding with the LE and other laws and regulations—that are mandatory for companies listed on the official market. The two codes contain distinct provisions and are not harmonized with each other. Neither code has been fully implemented at the time of this report, nor have no companies produced statements of compliance<sup>10</sup>.

**Principle IC. The division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served.**

**Assessment: Partially Observed**

The two entities have a large number of financial market regulators and capital market institutions. However, no regulator is specifically focused on company law, and oversight of the 1400+ JSCs is limited.

**Securities regulators.** Each entity has its own Securities Commission (SC) established under the respective LS and governed by a Law on Securities Commission (LSC). The FBiH SC began operations in 1999, the RS SC in 2000. They have authority over the issuing and trading of securities, the licensing of intermediaries, and a general—if ambiguous—mandate regarding investor protection and corporate governance. They also have specific powers under the respective LE, Law on Investment Funds and Law on Securities Register. However certain provisions of the LE and LS fall under the authority of local prosecutors.

<sup>8</sup> The two laws are the Law on Business Companies (FBiH) and the Law on Enterprises (RS); for simplicity, this report refers to each as a “Law on Enterprises” (LE).

<sup>9</sup> Private placements and block trading must be conducted through brokers and registered with the relevant stock exchange.

<sup>10</sup> Due to their recent introduction, this report only notes relevant provisions of the FBiH Code that coincided with the earlier Standards.

**Stock exchanges.** Each entity has one stock exchange, the Sarajevo Stock Exchange (SASE) for FBiH and Banja Luka Stock Exchange (BASE) for RS. Each exchange is a JSC owned by its member brokers and authorized by the relevant SC. Each exchange can warn and de-list listed companies. Unsurprisingly no de-listings have occurred as very few companies have listed voluntarily. Each exchange has a surveillance department (with two employees in Sarajevo and one in Banja Luka) that focus on compliance with the trading rules of the exchange. The exchanges also cooperate with the relevant SC, but do not consider the oversight of traded companies to be their responsibility.

**Central Registries/Depositories.** Each entity has a Central Registry of Securities (CRS) in which all securities, issuers and holders are registered. Shares are dematerialized in each entity: any change in ownership must be registered. The CRSs report that practically all JSCs are registered, the exceptions being companies at an early stage of privatization and some one person JSCs in RS. The RS CRS also performs clearing and settlement and act as a depository and provides net asset value calculations for RS PIFs. The FBiH CRS also effectively performs clearing and settlement—the law is being changed in this area to clarify the process. Banks act as PIF depositories in FBiH. The FBiH CRS was founded in 1999 and RS CRS in 2001. Each is state owned, and governed by a Law on Registry of Securities. There are plans in each entity to privatize the CRS.

**Company Registrars.** The Register of Business Companies is kept at municipal courts in each entity, and is also referred to as the Court Register. Companies are required to submit their documents of incorporation, including articles of association, list of founders, and record of nominal capital, to the local court register. If an incorporation or change is not registered, it has no legal standing. Each entity has passed new legislation to modernize and standardize company records, and DFID—the UK development agency—has provided significant support to allow for electronic filling and access. However conversion to the new system has been slow and significant delays remain, with new filings, changes in company documents, and registration of changes in capital taking up to nine months to finalize.

**Banking and other regulators.** Each entity has a Banking Agency that supervises banks and oversees the application of the entity banking law. The capabilities and independence of the Banking Agencies have been increased over the years, and each now actively polices the sector, with a number of banks being penalized and some put under new administration, sold to new owners, or liquidated. The corporate governance of banks falls under the entity level Banking Law as well as the LE and LS, and hence is regulated by both the Banking Agency and SC. The two agencies work closely with the Central Bank, and a single, state level, banking agency is planned.

**Coordinating Bodies.** The BiH Capital Market Council facilitates co-operation by regulators and institutions across the two entities. It includes representative of the finance ministries, securities commissions, stock exchanges and central securities registers as well as the state level ministry of finance and central bank. These institutions also maintain regular informal contact.

**Principle ID. Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfill their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained.**

**Assessment: Partially Observed**

**Authority, integrity and resources of regulators.** Each SC licenses brokers and PIF management companies and each maintain a registry of issuers in which JSCs are required to register. For issuers the SCs must approve the conversion of JSCs to limited liability companies, and oversee both mandatory and voluntary tenders. They can and have revoked licenses, can suspend trading and reverse certain decisions, set certain requirements for issuers, and have broad investigative powers, but cannot levy fines or pursue criminal actions, which are the responsibility of local prosecutors. This limits their authority over JSCs.

Each SC can and does issue implementing regulations and actively participates in the drafting and amending of legislation.

Each SC is an independent legal entity with a chairman, deputy chairman and three members who all serve 5 year terms. Neither has formal ties to other parts of the government, and members of government or parliament cannot serve on either commission. Each SC is self financed, and each has seen substantial growth in their budget over the last few years. The FBiH has 21 staff members plus the 5 members of the commission, the RS SC 12 staff members, plus the 5 members of the commission and 4 collaborators. The two SCs are joint members of IOSCO and regularly participate in local and international training and fora. Given their current mandate, the staff and budgetary resources of the two SCs seem adequate. However more active oversight of the large number of issuers would strain their current resources.

**Courts.** Each canton in the FBiH and each region in the RS has a single municipal court that takes all commercial cases, including those involving corporate governance issues. This allows for a certain degree of specialization; however market participants feel that the competence of the courts in commercial disputes remains limited, and cases take too long. In some cases the statute of limitations expires before trial is completed. Indicators developed by the World Bank imply that the procedures, time required, and cost of recovery to enforce a standard contract in BiH is typical for the region, but well above the OECD average, indicating that the courts are more costly to use than in more developed economies (See Doing

Business 2006 at [rru.worldbank.org](http://rru.worldbank.org).

Contract Enforcement Indicator	BiH	SEE Average <sup>11</sup>	OECD Average
Number of procedures	36	33.4	19.5
Time (days)	330	436.3	225.7
Cost (% of debt)	19.6	19.4	10.6

## SECTION II: THE RIGHTS OF SHAREHOLDERS AND KEY OWNERSHIP FUNCTIONS

The corporate governance framework should protect and facilitate the exercise of shareholders' rights.

**Principle IIA: The corporate governance framework should protect shareholders' rights. Basic shareholder rights include the right to:**

**Assessment: Largely observed**

(1) Secure methods of ownership registration	<p>All shareholder recordkeeping is carried out by two central share registries: the Registry of Securities of the Federation of Bosnia and Herzegovina (for companies registered in the FBiH) and the Central Registry of Securities (for companies registered in the RS). All shares are maintained in dematerialized form. The CRSs maintain share ownership records for all joint stock companies. Evidence of ownership is entry in the share registry. The law does not recognize the concept of nominee ownership. Recent regulations in the FBiH establish and regulate the operations of custodians (although no custodians are operating in practice).<sup>12</sup> In the RS, there is no law regulating custodians.</p> <p>Each CRS has been successful in moving towards 100% compliance with registration requirements. Discussions with registries and market participants do raise some potential concerns, including identity theft and involuntary sale of shares (in the FBiH), slow compliance in the past by strategic companies in both entities, and small discrepancies between the number of companies in the central registries and in the court registries. The central registries are aware of these problems and are working to resolve them.</p> <p>Depositaries (which hold shares and provide certain other services for the PIFs) are governed by the same Regulations in the FBiH, and the depositary function is carried out by a depositary bank. In the RS, depositary activities are performed by the CRS.</p>
(2) Convey or transfer shares	<p>All purchase and sale of shares (other than gifts or inheritances) must be carried out on the relevant exchanges. Only shares registered in the central registries can be traded on the exchanges. The central registries are responsible for clearing and settlement, and transactions are settled in DVP on T+3. Systems in both entities are based on systems developed by the KDD in Slovenia. Clearing and settlement is more sophisticated in the RS, which has implemented a multilateral netting / guarantee fund system. Both entities are working to gradually move towards full international standards in this area; however, the small size of the two markets will make acceptance by international custodians difficult.</p> <p>In general, share transfers may not be restricted by management or large shareholders. In the FBiH, the sale or transfer of shares (excluding inheritance) may be banned or otherwise restricted for certain periods through a shareholder agreement. Securities issued through closed sale may not be sold, pledged or otherwise disposed of in any manner, within one year as of the registration in the Securities Register except by inheritance or under the force of law, to an issuer when the law allows it, or to the existing shareholder. In the RS, the articles of association may restrict the transfer of shares of joint stock companies that are not traded on the stock market, through management consent or pre-emptive right of other shareholders (LE, §229).</p> <p>In FBiH, JSCs may issue employee shares that can only be sold to other current or retired employees. These employee shares may not exceed 5% of the company's nominal capital.</p>
(3) Obtain relevant and material company information on a timely and regular basis	<p>In each entity shareholders can demand to see documents at the company (FBiH LE §216, RS LE §82, 323). In the FBiH the law specifies that this includes founding statutes, balance sheet and other documents that must normally be provided at the GMS, reports on taxes paid for three years, minutes of the GMS and audit board, and a list of</p>

<sup>11</sup> Average for South East Europe: Albania, BiH, Bulgaria, Croatia, Macedonia, Romania, Serbia and Montenegro.

<sup>12</sup> Regulations on Activities of Custodians and Depositaries on the Securities Market.

	<p>management and board members with functions they perform for other legal persons.</p> <p>Shareholders in each entity can also obtain company information from a number of other sources (see VE).</p>
(4) Participate and vote in general shareholder meetings	All shareholders in each entity have the right to attend the GMS. Holders of ordinary shares have the right to vote, as do holders of preferred shares under certain circumstances (see IIIA).
(5) Elect and remove board members	<p><b>Process.</b> In FBiH the supervisory and audit board are elected by shareholders in the GMS. Shareholders with 5% or more voting shares may propose nominees (FBiH LE §261). In RS, members of the management and supervisory board are elected by shareholders in the GMS, and there are no special rules for nomination by minority shareholders.</p> <p>In SOEs, the LPE requires that supervisory board positions be advertised, and that a committee chosen by shareholders rate the qualifications of various candidates. Informed by the committee, the supervisory board members are chosen by the GMS. Members of the management board are chosen by the supervisory board.</p> <p><b>Cumulative voting/proportional representation.</b> The FBiH LE and banking law in each entity have been amended to require cumulative voting, however the provisions are not well understood. The RS LE (§257) states that “The statute(s) of a joint stock company provides for” minority shareholders to be represented on the management board. In SOEs, the LPE in each entity allows for minority shareholders to choose one member of the supervisory board.</p> <p>In practice, many JSC boards have members who are considered to represent small shareholders.</p>
(6) Share in profits of the corporation	Shareholders are entitled to dividends proportional to their holdings. The GMS decides on the dividend payment, though dividends may not be paid, or paid only to preferred shareholders, if the company's net assets and reserves are insufficient (FBiH LE §206, 207; RS LE §225). In RS, GMS decides after obtaining the opinion of the supervisory board or auditor (RS LE §61). Neither entity has a minimum mandatory dividend.
<b>Principle IIB. Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as:</b>	
<b>Assessment: Materially not observed</b>	
(1) Amendments to statutes, or articles of incorporation or similar governing company documents	The GMS in both entities has sole authority to amend the company statutes. In FBiH, this must be done with a 2/3 supermajority (FBiH LE, §246). In RS, amendments must be made by a simple majority of <i>all</i> voting shares (RS LE, §252), but the company statutes can specify a lower majority requirement.
(2) Authorization of additional shares	<p><b>Issuing share capital.</b> In the FBiH, increases of registered capital can be made by the GMS, by 2/3 supermajority following a proposal from the supervisory board (FBiH LE §131). However, the law permits the GMS or the company statutes to empower the supervisory board to increase capital by up to 33%. This permission can only be given for a period of 5 years. Any capital increase must be registered at the register court; the slow speed of the court registry (9+ months) has reportedly forced many companies to issue shares quasi-legally.</p> <p>In RS, the company statutes or the GMS may authorize the managing board to increase share capital up to a certain level (authorized share capital), up to a limit of 50 percent increase. The supermajority requirement can be lowered to another majority by the company statutes. The managing board can then issue shares up to the level of authorized capital, although the law is relatively silent on specific board procedures.</p> <p><b>Pre-emptive rights.</b> Shareholders in both entities have pre-emptive rights in the case of new share issues. In FBiH, existing shareholders have the right to buy new shares within 30 days of the deadline for registering new shares. (FBiH LE §213)</p> <p>However, in both entities rights can be waived. In FBiH, pre-emptive rights are denied to shareholders who oppose the capital increase, and can be waived by a separate simple majority right of votes present (FBiH LE §214&amp;215). In RS, pre-emptive rights can be restricted in the original decision on capital increase (which, as noted above, can be carried out by a simple majority of votes present, depending on the company statutes) (RS LE §280.3).</p>

(3) Extraordinary transactions, including sales of major corporate assets	<p><b>Sales of major corporate assets.</b> In FBiH, the GMS is required to decide on all “purchase, sale, exchange, leasing and other transactions with property, directly or through subsidiary companies within a business year” that are larger than 1/3 of net book value. In addition, the GMS must decide on any transactions between 15% and 33% of net book value where there was not unanimous approval by the supervisory board (LE FBiH, §246).</p> <p>However, in RS, there appear to be no specific legal requirements that govern large transactions, other than the Law on Competition (which covers mergers and which applies in both entities). The new voluntary Code encourages the GMS to approve sales or investments that equal or exceed 10% of the companies’ assets.</p>
<b>Principle IIC: Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings:</b>	
<b>Assessment: Largely observed</b>	
(1) Sufficient and timely information on date, location, agenda, and issues to be decided at the general meeting	<p><b>Meeting deadline.</b> JSCs in each entity must hold a GMS at least once a year (FBiH LE §241; RS LE §246). In FBiH the supervisory board calls for the meeting, in RS the management board does. While somewhat unclear, FBiH law is generally interpreted as effectively requiring the GMS be held within 5 months of the end of the year. There are no restrictions or guidelines on when during the year the meeting must be held in RS.</p> <p><b>Meeting notice and available information.</b> In FBiH, a notice on the agenda, place, date and time of the GMS must be published at least 30 days prior to the meeting in a daily newspaper. If the meeting is not held at the company seat, then the notice must be delivered directly to shareholders (FBiH LE §242). Shareholders have the right to access the JSCs financial statements and the reports of the auditor, supervisory board and audit board from the day the notice is published; the voluntary Code call for issuers to provide shareholders with a copy of the annual report and detailed information on any potential conflict of interest involving board members or proposed transactions.</p> <p>In RS, notice must be given at least 21 days in advance “in a way regulated by statutes” and must be accompanied by the agenda (RS LE §246,248). In practice, notice is normally also given through publishing in a daily newspaper. Shareholder representatives from past meetings, as well as representatives of the supervisory board, must be informed 8 days later (RS LE §249).</p> <p><b>Quorum rules.</b> In FBiH the quorum requirement is at least 30% of voting shares. The statutes can provide for a higher threshold. If the quorum is not met, then a second meeting must be called within 15 to 30 days. The second meeting has a 10% requirement (FBiH LE §245). In RS the quorum requirement is 50% in the first meeting and 20% in the second for most JSCs (RS LE §252). In RS PIFs the requirements are lower: 20% in the first meeting and, effectively, none in the second.</p> <p>Quorum requirements for all companies in FBiH and for PIFs in the RS were reduced—the previous threshold in each case was 50%—due to problems reaching quorum at PIF shareholder meetings, most of which have several thousand shareholders.</p>
(2) Opportunity to ask the board questions at the general meeting	<p><b>Forcing items onto the agenda.</b> The GMS may only decide on issues included in the agenda. Shareholders with 5% or more of the voting rights in FBiH and 10% in RS can amend the agenda within 8 days of receiving it (FBiH LE §243, RS LE §248). In FBiH, but not RS, the supervisory board must publish an amendment to the agenda in the same way the agenda was originally published.</p> <p><b>Questions.</b> In RS, shareholders may send questions regarding the agenda in writing to the management board at least 8 days before the GMS. The management board must provide a written response. In both entities until recently there were no provisions for questions during the meeting. Market participants have indicated that at the GMS of some JSCs questions may be asked, however rigid adherence to the agenda limits questions at other JSCs. The new voluntary Code in the RS notes that shareholders may express their opinions and ask questions regarding agenda items.</p>
(3) Effective shareholder participation in key governance decisions including board and key executive remuneration policy	<p>In FBiH, the GMS decides on the remuneration of supervisory and audit board members, but not that of management (FBiH LE §246). In RS, the GMS decides on the remuneration for management and supervisory board members (RS LE §61, 265-267, 276).</p> <p>In each entity the GMS decides on amendments to the statutes, changes in share capital and the issue of new shares, changes in form and termination of the JSC, and dividends</p>



	(FBiH LE §246, RS LE §61, 245). The GMS in FBiH must also approve certain major transactions.
(4) Ability to vote both in person or in absentia	<p><b>Proxy regulations.</b> LE in each entity allows for voting by proxy. The proxy must contact the supervisory (FBiH) or management (RS) board prior to the meeting and must have written authorization (FBiH LE §250; RS LE §249,254). While not explicitly required, the authorization may need to be notarized to be considered authentic. Under RS LE, the proxy is valid for subsequent meetings. RS LE excludes members of the supervisory or management board from serving as a proxy.</p> <p><b>Postal and electronic voting.</b> In each entity, statutes may allow for voting by mail (FBiH LE §250; RS LE §254).</p> <p>In practice voting by proxy is not uncommon. This includes representation through shareholder associations for particular companies. Voting by mail, while not as common, is also used.</p>

**Principle IID: Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.**

**Assessment: Partially observed**

Ownership structures tend to be simple—without cross-shareholdings or pyramid structures—and legislation requires companies, owners and intermediaries to disclose direct and indirect ownership. However in practice only significant direct ownership is disclosed and market participants have noted cases where control is opaquely exercised through controlled and affiliated parties. The recent decision by each CRS to list the top ten owners of each JSC should reduce this opacity.

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**Classes of shares.** In each entity JSC may issue ordinary shares, each of which has one vote, or preferred shares that have priority regarding dividends but only provide voting rights for certain GMS decisions or when dividends are not paid (see IIIA; FBiH LE §217-220; RS LE §216). In FBiH JSCs may also issue employee shares that can only be transferred to other current and retired employees. The latter is limited to 5% of nominal capital. Ordinary shares make up the great majority of shares in each entity. Shares with multiple votes are not allowed. The RS LE seems to allow for voting caps (§217), but these are not widely used in practice.

**Ownership disclosure by companies.** In FBiH, law and regulation requires the company to disclose overall employee ownership, ownership by supervisory board members and management, and both the ownership and share trading of persons with 5% or more of the company. In RS companies are also required to disclose ownership by supervisory and management board members, as well as the ownership of the ten largest shareholders. The new voluntary Code encourages companies to make their ownership public and available on a daily basis.

Companies in each entity are to provide shareholders a list of shareholders and proxies before the GMS, and are nominally required to report persons with “relevant influence” under IAS 24.

**Ownership disclosure by shareholders.** Each entity requires owners with 5% or more to disclose ownership and changes in ownership to the SC, issuer and or stock exchange. This information is not passed directly on to the public.

**Disclosure of shareholder agreements.** Shareholder agreements are not regulated under the law and their use is confined to a limited number of foreign investors.

**Principle IIE: Markets for corporate control should be allowed to function in an efficient and transparent manner.**

**Assessment: Partially Observed**

(1) Transparent and fair rules and procedures governing acquisition of corporate control	<p><b>Basic description of market for corporate control.</b> The market for corporate control in BiH is driven primarily by major shareholders in privatized companies increasing their ownership. This includes foreign owners, who have been especially active in the banking sector, and some PIFs in RS, but not entities or cantons, which are major owners and which continue to privatize. In 2004 major shareholders made tender offers to other shareholders in 21 companies in FBiH and 39 in RS. As ownership consolidates, JSCs are also converting to limited liability companies: in FBiH in 2004 25 JSCs converted. Markets have also seen a small number of mergers and at least one hostile takeover in a PIF, where shareholders in the fund replaced the management company.</p> <p>Approval is needed from the state level Competition Council for large scale mergers or acquisitions and from the entity level banking and insurance supervisors for certain control transactions involving banks and insurance companies, respectively. Each entity has a Law on Investment Funds and additional regulations that provide the requirements for PIF GMS to change the PIF management company. Management companies are licensed by the SCs, and any such change would require their approval.</p> <p><b>Tender rules/mandatory bid rules.</b> Each entity has a mandatory bid rule which the SCs</p>
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	<p>actively enforce. FBiH Law on takeovers requires a shareholder with 30% or more ownership in a JSC with at least 40 shareholders to offer to buy the shares of other shareholders at a price equal to the highest price the bidder paid over the last six months or the six month average on the stock market, whichever is greater. The bid must be approved by the SC and publicized in the press, electronic media, or by directly contacting shareholders. The RS Law on Takeovers of Joint Stock Companies requires shareholders with 25% or more to make the offer at the highest price paid over last year or three month stock market average. The bidder must notify the SC and JSC and publish the offer in the Official Gazette and a daily newspaper.</p> <p>The rules in each entity allow the bidder to set the minimum number of securities that must be tendered for the offer to be binding, and this may allow for the bidder, by setting a high threshold, to avoid having to honor the bid. In practice however, most tenders that take place are mandatory, and this has led to some consolidation of ownership.</p> <p><b>Delisting/going private.</b> JSCs on the official market can be delisted by the exchange for not complying with listing requirements, by the SC, or by a decision of the GMS. However, only three companies are listed voluntarily. The rest are traded on the free market and cannot be removed given requirements in each entity that shares be traded through the exchange.</p> <p>A JSC can leave the free market by converting to a limited liability company. In FBiH, conversion requires approval of the GMS by a 2/3 majority and approval of the SC (FBiH LE §287-290). The RS LE requires the GMS approve the change in company form with a ¾ majority or a majority given in the statutes. Shareholders must be contacted about the change, and those that dissent can demand that the company buy back their shares, or convert them into preference shares (RS LE §252, 421).</p> <p>Market participants have reported of at least one case where dissenting shareholders appealed to the courts to reverse a conversion.</p> <p><b>Squeeze out provisions.</b> In the RS, merger rules allow a JSC that controls 90% of another JSC to buy out the remaining 10% of shareholders (RS LE §402). There are no provisions in either entity where a minority shareholder would be compelled to sell shares to a controlling shareholder who was a physical person.</p> <p><b>Share buy-backs/treasury shares.</b> Under certain circumstances, JSCs can buy back and cancel up to 10% of nominal equity. In RS, bought back shares may also be resold to employees.</p>
(2) Anti-take-over devices	<p>In FBiH, regulations restrict the company from issuing new capital after the offer has been made, and prohibit members of the supervisory board or management from proposing "to shareholders or to adopt any by-law, contract or other device to impede a tender offer, unless the device is designed to obtain a better price for shareholders or to prevent changes in control of the company without the consent of a majority of share votes". The regulations require the supervisory board to provide an opinion on the offer. The LE in each entity prevents the staggering of terms for board members and allows new owners to change the board at the GMS.</p> <p>In practice, continuing state ownership and large control stakes in fully privatized companies—facilitated by the switch to tender privatization in each entity—limit the need for anti-take over devices. One exception is the PIFs, which have dispersed owners who can, and have in at least one case, change the management company of the fund.</p>
<b>Principle IIF: The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated.</b>	
<b>Assessment: Partially Observed</b>	
PIFs, brokers with shares on their own account, and the pension fund in the RS are all active in GMS. PIFs in the RS hold controlling stakes in some companies.	
(1) Disclosure of corporate governance and voting policies by institutional investors	<p><b>Special Rules for Institutional Investors / Pension Funds.</b> The law does not explicitly address this area. In practice, PIFs and the RS Pension Fund have the same ownership rights and obligations as other shareholders.</p> <p><b>Voting Policy.</b> Neither entity requires or encourages disclosure of voting or the formulation or disclosure of policies dealing specifically with governance. The RS LE (§ 251) notes that GMS minutes can contain the views of particular shareholders.</p> <p><b>Blocked shares/record date.</b> In FBiH, the records of the CR 30 days before the GMS determine the list of shareholders eligible to participate in the meeting and their voting</p>

	rights. In the RS, participation is based on CR records on the day the meeting was called. Trading in shares is not blocked before the GMS.
(2) Disclosure of management of material conflicts of interest by institutional investors	In each entity, the relevant Law on Investment Funds and implementing regulations contains provisions to manage conflicts of interest in PIF funds and management companies <sup>13</sup> . Relevant provisions of the LE also apply. Neither entity requires the formulation or disclosure of policies dealing specifically with conflicts of interest.
<b>Principle IIG: Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse.</b>	
<b>Assessment: Largely/Partially Observed</b>	
<p>Institutional investors and minority shareholders regularly consult with each other during the GMS. Major companies also have shareholder associations that represent small shareholders. Under the law, shareholders can access the list of shareholders and proxies at the company before the GMS, however, limited access to ownership information in practice may hinder some kinds of legitimate cooperation while facilitating certain abuses.</p> <p><b>Proxy solicitation or other formalities required.</b> Shareholders may communicate without meeting proxy or other formal requirements.</p> <p><b>Rules on shareholder cooperation and “acting in concert”.</b> Takeover law and regulations require related parties or parties acting in concert to make a mandatory tender if their total ownership is high enough (see IIE), however there are no restrictions or special requirements regarding shareholder communication. In practice, market participants have noted cases where companies are effectively controlled through undisclosed relationships.</p>	
<b>SECTION III: THE EQUITABLE TREATMENT OF SHAREHOLDERS</b>	
The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.	
<b>Principle IIIA: All shareholders of the same series of a class should be treated equally.</b>	
<b>Assessment: Partially Observed</b>	
(1) Equality, fairness, and disclosure of rights within and between share classes	<p><b>Availability of share class information.</b> In each entity the investor can request the JSC to provide the CRS excerpt detailing the rights of a particular security. They cannot request this information directly. The total number of each type of share issued by the company is normally available through the stock exchange web site, in annual and semiannual reports, and at the local court register.</p> <p><b>Equal rights within classes.</b> The LE in each entity specifies that shareholders of the same class have the same rights and are considered equal.</p> <p><b>Approval by the negatively impacted classes of changes in voting rights.</b> In FBiH, LE doesn't address changes in the rights attached to a particular class of shares, but does give non-voting preferred shareholders voting rights for certain major corporate events (FBiH LE §220). The LS and regulations require the GMS and SC approve conversion of securities—“the withdrawal of all securities of the same class and their replacement with new securities of another class”. In RS, the GMS decides on changes in the right of share classes, but shareholders with non-voting preferred shares must agree to any changes in their rights in a special assembly (RS LE §245, 256). Preferred shareholders who are not paid prescribed dividends gain voting rights under both LEs.</p>
(2) Minority protection from controlling shareholder abuse; minority redress	<p>Shareholders have a number of powers under the law that have seen limited use in practice.</p> <p><b>Ability to call meeting.</b> Shareholders in each entity with at least 10% ownership can call for a GMS by making a written request that includes the purpose of the meeting (FBiH LE §244,344; RS LE §247). In FBiH the request is made to the supervisory board, if the supervisory board does not act, the shareholders can call the meeting directly by providing written notice to the SC. Shareholders may also call the meeting directly if the supervisory board has failed to do so five months after the end of the business year. In the RS the request is made to the management board, if that board fails to call the meeting, it may be</p>

<sup>13</sup> The RS law includes the requirement to maintain a register of all share trading by board members, shareholders, and employees. The register is subject to inspection by the SC and other parties that “have a legal interest”.

	<p>called directly, and or called by the supervisory board. If for some reason the meeting still does not take place, the shareholders may demand the company buy back their shares.</p> <p><b>Inspection Rights.</b> In each entity shareholders can demand to see documents at the company (See IIA3). In FBiH shareholders with 10% or more of shares can also request the Audit Board to perform an audit, and those with 20% or more can call for a special examination by an outside auditor (FBiH LE §285,255). In the RS, shareholders with 10% or greater ownership can request an examination of “accounting reports or investment decisions” by an outside expert (RS LE §81)</p> <p><b>Withdrawal rights.</b> In FBiH, shareholders who dissent from certain decisions of the GMS—including capital increases, dividend payments, and mergers—can demand the company purchase their shares at the thirty day average market price (FBiH LE§255). RS LE does not have similar requirements.</p> <p><b>Ability to challenge decisions of the general meeting.</b> In the FBiH, a shareholder that was not present at the GMS due to improper notification or whose decision or dissent was not properly recorded can go to court to contest and annul the decisions of the meeting (FBiH LE §257,258). In the RS, shareholders with at least 10% ownership can go to court to overturn a decision they consider illegal (RS LE §79).</p> <p><b>Regulator redress.</b> While the SC in each entity has explicit authority for “investor protection”, authority over issuers is limited. Each SC can launch investigations and refer cases to local prosecutors, but cannot fine issuers or suspend or reverse corporate decisions. No other regulator has authority regarding shareholder protection or the LE.</p> <p><b>Ability to sue board members or directors.</b> In the FBiH shareholders cannot file suits against board members or management for breach of duties or other legal provisions. Only the company can take civil action in these cases. Derivative suits are not allowed. In the RS shareholders with at least 10% ownership can sue members of the management board or supervisory board for negligence. They are entitled to damages and the court can annul a negligent decision. The suit must be filed within 90 days of the decision. Under certain circumstances, a shareholder can also bring an individual complaint against an “enterprise authority” (RS LE §72-77). It is not clear that any such suits have been filed.</p>
(3) Custodian voting by instruction from beneficial owners	The law does not recognize nominees or beneficial ownership, and custodians are not explicitly addressed in either LS. Regulations in FBiH do allow for banks to act as custodians, and the voluntary Code notes that intermediaries who hold shares for others should seek instructions with regard to voting in the GMS. However it is not clear that this language is applicable under the current legal framework. In practice only the registered shareholder or their designated proxy may vote.
(4) Obstacles to cross border voting should be eliminated	There are no limits on foreign ownership of securities or financial intermediaries in BiH, and investors from Slovenia and other countries are active participants in local capital markets. Foreign investors must comply with the same rules for voting by proxy and mail as other shareholders, and do participate in the GMS of some JSCs.
(5) Equitable treatment of all shareholders at GMS	<p>The law requires equal treatment of shareholders of the same class at the GMS, allows for voting by proxy and mail—which are used in practice—and requires the company to make a special notification if the meeting is not held at the company seat. The voluntary FBiH Code contains additional provisions to facilitate small shareholder participation in the GMS of “issuers with widely held shares”.</p> <p>In practice, the rigid rules regarding the agenda (see IIC) may limit participation by some small shareholders. However minority shareholders and the proxies and funds that represent them are active in the meetings of many JSCs.</p>
<b>Principle IIIB: Insider trading and abusive self-dealing should be prohibited.</b>	
<b>Assessment: Partially Observed</b>	
<p><b>Basic insider trading rules.</b> The FBiH LS (§117) defines inside information as information that “provides an advantage” to the possessor in the trade of securities or information that “may influence the price of securities”. This information may not be disclosed without authorization, may not be disclosed to third persons, and may not be used when purchasing or selling shares (§119). The RS LS (§106) defines inside information as “very precise” undisclosed information that “if published could have a significant influence on a price of securities”. The law prohibits buying or selling shares based on inside information and passing on the information to others who might profit from it.</p> <p><b>Insider trading disclosure.</b> Under the FBiH LS (§118) management, supervisory board members, and others whose position may allow for the acquisition of insider information, or who have received inside information, are required to report share transactions to the SC. The RS LS (§105) requires the director, members of either board, and owners of 10% or more</p>	

of the JSC to submit to the SC reports of all share transactions.

**Criminal/civil/administrative penalties.** In FBiH insider trading can lead to a fine of 1,000 to 5,000 KM and 3 to 5 months in prison, as well as compensation for damages. It is not clear that there is a penalty for failing to disclose trading. The RS LS provides for a fine of 1,000 to 5,000 KM for failure to disclose trading, and 3 months to 5 years in jail for insider trading as well compensation for damages. While the licenses of some brokers have been suspended for abusing privileged information, to date, no corporate insiders in either entity have been punished for trading using inside information or passing that information on to someone else. Fines remain too low to deter violations.

**Principle IIIC: Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.**

**Assessment: Materially Not Observed**

**RPT disclosure rules.** Under IAS 24—incorporated into the accounting standards of both entities—companies are required to disclose related party transactions. However compliance is minimal. In FBiH the voluntary Code requires disclosure to shareholders whenever a member of the supervisory board or management “enters into a transaction of substantial value with the company or its subsidiary”.

**RPT approval rules/rules for approval of board/AGM.** There are no rules requiring shareholder or board approval of related party transactions. Under the LPE in each entity, SOEs are required to comply with regulations on public sector procurement and the law provides guidelines for supervisory and management boards on implementing this requirement.

**Conflict of interest rules and use of business opportunities.** In FBiH members of the supervisory board must declare any interest they have in a transaction or business relationship to the rest of the board, and cannot participate in a decision involving that interest (FBiH LE§270). Senior management must report potential conflicts of interest to the supervisory board, and require the written consent of the chairman of the supervisory board to “participate in such a business relation” (FBiH LE§279). “Shareholder may not vote, on decisions that concern his/her acts, responsibility and claims of the joint stock company against him/her” (FBiH LE§199). The voluntary Code calls for the disclosure of potential conflicts of interest to shareholders before the GMS.

In RS, board members and management must receive the approval of both boards to receive “a contract for a loan, deposit, warranty, guarantor and collateral, as well as the other legal business determined by the founding charter”. Shareholders must be informed when such approval is given (RS LE §89). There seem to be no such requirements for board members with an interest in a legal person that the company enters into a business relationship with. Shareholders with a potential conflict of interest must recuse themselves from voting in the GMS (RS LE §255). The new voluntary Code also calls for disclosure of conflicts of interest involving something to be decided in the GMS

Banking law in each entity allows management, board members, and large shareholders of a bank to borrow from it, as long as no favoritism is shown in making the loan. The LPE in each entity prohibits board members and other employees from “entering into any actual or apparent conflict of interest”, and requires disclosure to the supervisory or management board any transaction or relationship that could lead to a conflict of interest loans. SOEs are prohibited from making loans to their employees.

#### SECTION IV: THE ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE

**The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.**

**Principle IVA: The rights of stakeholders that are established by law or through mutual agreements are to be respected.**

**Assessment: Partially Observed**

While each entity has its own laws regarding stakeholder protection, these laws have a number of common provisions, and there are few significant differences. Employees and creditors in particular have significant protection under the law, as well as under the privatization agreements which apply to a number of companies. However each entity also has a large “grey economy”, whose participants operate outside the legal framework for stakeholders.

**Stakeholder participation in corporate governance.** Employee share ownership is widespread, and this ownership and trade union influence allow some employee participation in corporate governance. The voluntary Code in FBiH state that “No supervisor or manager shall threaten an employee-shareholder with job-related retaliation for exercise of shareholder rights”, the new voluntary RS code has a similar provision. However, in each entity market participants have noted that some employee-owners do face pressure to support management.

Each entity now also requires companies with 15 or more employees to have “Employee Councils” similar to worker councils required for employers in the European Union. The employer is required to consult with the council on restructuring that may impact employment and other employee related issues. In practice council mandates remain ambiguous and their role limited.

**Corporate social responsibility and codes for stakeholders.** In spite of the importance of the re-emerging and nature-oriented tourist industry and the large number of non-governmental organizations operating in BiH, general awareness of environmental issues and corporate social responsibility appears to be limited. Each Cantonal Chamber of Commerce in the FBiH has prepared a Code of Ethics for its members, but the impact of these codes has been limited to date. The new voluntary RS Code notes that companies should take into consideration the interest of stakeholders, particularly employees.

**Obligations of companies with state capital.** Companies where entities or cantons are important owners (SOEs) may have special, if implicit, obligations to stakeholders. However these non-commercial objectives are generally not well-defined or consistent through time.

**Principle IVB: Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.**

**Assessment: Largely Observed**

**Redress mechanisms available to stakeholders.** The violation of creditor or employee rights and “irresponsible business dealing” are criminal offenses, and can be prosecuted by the relevant authority. Creditors also have additional redress in the case of bankruptcy, and employees through trade unions, which are a major presence in some industries.

A single state-level law on mediation has recently been introduced, and donors are supporting the development of alternative dispute resolution for stakeholders under these laws.

**Principle IVC: Performance-enhancing mechanisms for employee participation should be permitted to develop.**

**Assessment: Partially Observed**

Employee share ownership is common due to privatization, with many employees having at least some shares in their company, and managers in some companies acquiring large positions. Shares or share derivatives are not used as compensation, though such compensation is not forbidden under the law. The use of other performance-based pay in joint stock companies also remains limited.

**Principle IVD: Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis.**

**Assessment: Materially Not Observed**

Stakeholders in most companies only have access to the same basic financial and corporate information that shareholders do, with few companies releasing annual or other reports that discuss economic and financial prospects, important risk factors, etc. Employees may have better access to information through consulting requirements provided in the Labor and Employee Council law in both entities and the RS LE (§85), though in practice such disclosure is limited. The RS LE also gives third parties explicit rights to access certain company documents (§84).

**Principle IVE: Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this.**

**Assessment: Materially Not Observed**

**Whistleblower rules.** Employees may be able to express certain concerns through their trade union representatives or employee council, however there is no law specifically protecting whistleblowers in private sector JSCs.

In SOEs, supervisory and management board members have a duty to “encourage employees to report evidence of illegal or unethical behavior to appropriate enterprise officials”.

**Principle IVF: The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights.**

**Assessment: Largely Observed**

Commercial credit has grown strongly as both entities have experienced significant restructuring of the banking sector through privatization, liquidation and large scale foreign investment. The regulatory framework has also been enhanced and continues to develop as competencies move to the state level. Credit to the private sector in BiH reached 21% of GDP in 2004, bringing it ahead of several other transition economies<sup>14</sup>.

**Effectiveness of bankruptcy, security/collateral, and debt collection/enforcement codes.** The adoption of new laws on bankruptcy procedures in 2002 in the RS and 2003 in FBiH have significantly strengthened the protection of creditors' rights.

<sup>14</sup> Economist Intelligence Unit.

The standing Law on Obligations also provides important protections. Creditors are now able to realize their claims in a timely manner, and the number of finalized liquidations has increased. The laws also allow for reorganization instead of liquidation, although this requires the consent of each class of creditors and its use has been limited. Standard measures developed by the World Bank confirm that legal rights for creditors are strong and access to credit information and the coverage of BiH's donor and central bank supported credit bureau well above the average for the region. See Doing Business 2006 at [ru.worldbank.org](http://ru.worldbank.org).

Indicators of Creditor Protection	BiH	SEE Average <sup>15</sup>	OECD Average
Legal Rights Index (out of a possible 10)	8.0	6.0	6.3
Credit Information Index (out of a possible 6)	5.0	2.3	5.0
Public credit registry coverage (% of adult population)	0.0	2.4	7.5
Private bureau coverage (% of adult population)	19.3	2.9	59.0

## SECTION V: DISCLOSURE AND TRANSPARENCY

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

**Principle VA: Disclosure should include, but not be limited to, material information on:**

**Assessment: Materially Not Observed**

(1) Financial and operating results of the company	<p><b>Annual report.</b> Laws on securities, enterprises, public enterprises, banking, and accounting and auditing as well as SC regulations in the two entities have various annual reporting requirements. JSCs in each entity are required to produce annual financial statements and the reports of the auditor, and either supervisory and audit board (FBiH) or supervisory and management board (RS) to be presented to the GMS and available to shareholders. Annual financial statements must be audited and consolidated, and filed with a specialized agency—FIPA in FBiH and AFIP in RS.</p> <p>Regulation in the RS requires JSCs whose securities are owned by at least 100 shareholders or one PIF to publish summarized annual financial statements and a report on major events and activities in a daily newspaper. JSCs with tradable securities (practically all) must also provide annual business statements to their SC and stock exchange, including summary financial statements, the auditors report, and a discussion of recent developments and future plans.</p> <p><b>Semi-annual report.</b> The LS in each entity requires JSCs to produce semiannual business statements. These include basic, unaudited, financial data.</p> <p><b>Quarterly report.</b> PIFs in FBiH are required to produce quarterly reports, other JSCs in BiH are not.</p> <p>With a few exceptions, reports tend to be rudimentary. Less than half of the JSCs in each entity publish statements or provide them to the SC or stock exchange.</p>
(2) Company objectives	<p>Founding statutes of companies are available through the relevant court register, and these may contain company objectives, though in practice the statutes of many JSCs tend to be of a basic nature. Access to court registry records (including company statutes) has traditionally been difficult, although the on-going project to modernize the court register is expected to improve the situation. Securities commission regulations in both entities require disclosure of ongoing investment and future plans in the annual statement, however compliance with these requirements is minimal. The new voluntary RS Code requires companies to disclose development plans and corporate objectives.</p>
(3) Major share ownership and voting rights	<p>In FBiH, law and regulation requires the company to disclose overall employee ownership, ownership by supervisory board members and management, and both the ownership and share trading of persons with 5% or more of the company. The RS also requires companies to disclose ownership by supervisory and management board members, as well as the ownership of the ten largest shareholders. Each entity requires owners with 5% or more to disclose ownership and changes in ownership at 5% intervals. Professional intermediaries are also required to report large transactions involving 5% or more of a</p>

<sup>15</sup> Average for South East Europe: Albania, BiH, Bulgaria, Croatia, Macedonia, Romania, Serbia and Montenegro.

	<p>particular security.</p> <p>While legislation in both entities refers to indirect ownership, there is no legal definition and the term has little practical meaning. Only direct ownership is reported.</p>
(4) Remuneration policy for board and key executives, and information about directors	<p>In FBiH the annual statement must include the age, qualifications, current job and jobs during the last three years of all management and supervisory board members as well as the person or persons that proposed him/her for the current position and membership in the supervisory boards of other companies. It must also indicate the total of all types of remuneration during the statement period and remuneration expected for the following tax year for members of the supervisory board, management, auditing board and three company employees with highest remuneration. In RS the company must disclose the name, the position, and the percentage of ownership of the board members and key executives.</p>
(5) Related party transactions	<p>Under IAS 24—incorporated into the accounting standards of both entities—and SC regulations in FBiH, companies are required to disclose related party transactions. Compliance is minimal.</p>
(6) Foreseeable risk factors	<p>SC regulations in each entity requiring disclosure of future plans. The new voluntary RS Code encourages disclosure of mechanisms for risk management. There are no other explicit requirements regarding risk factors or relevant internal controls. For SOEs, the LPE in each entity requires the Internal Audit Department to produce a risk assessment that is provided to the Audit Board and the Supreme Audit Authority. It is unclear if this is also disclosed to shareholders (other than the state) or the public.</p>
(7) Issues regarding employees and other stakeholders	<p>In RS the new voluntary Code encourages companies to disclose certain issues related to employees and other stakeholders. With the exception of employee ownership in FBiH, there are no other explicit requirements to disclose on employee or stakeholder issues in the annual statement or other statements provided to the public, SC, or stock exchange.</p>
(8) Governance structures and policies	<p>Recently, each entity has required companies to disclose compliance with their Codes. None have done so to date.</p>
<p><b>Principle VB: Information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure.</b></p>	
<p><b>Assessment: Partially Observed</b></p>	
<p><b>Compliance with IFRS.</b> Until recently each entity had its own accounting standards, which under the law were to be based on IFRS. In practice, each set of entity standards had important difference from IFRS, and from the standards of the other entity<sup>16</sup>. The same accounting standards were required for all JSCs, the vast majority of which are best described as small and medium enterprises, and would normally have difficulty in fully complying with either IFRS or the standards used in each entity.</p> <p>A state level Framework Accounting and Auditing Law (FAA) was passed in 2004, and enabling legislation passed in each entity more recently. This creates a new state-level Independent Standards Commission (ISC) and requires full IFRS compliance for all companies with revenue of one million KM or greater or 50 or more employees. However this legislation had yet to be fully implemented at the time of this assessment. The 2004 LPE in each entity also calls for SOEs to comply with IFRS.</p> <p>While most JSCs do produce financial statements, compliance with either local or international standards has been partial. To date, only those companies with foreign ownership or finance have produced information in accordance with international standards.</p> <p><b>Review/enforcement of compliance.</b> To date, compliance with entity accounting standards has been essentially voluntary. The exception is banks, which do face some regulatory review of financial statements. The FAA and enabling legislation provides for the review of statements by the ISC.</p>	
<p><b>Principle VC: An annual audit should be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.</b></p>	
<p><b>Assessment: Partially Observed</b></p>	

<sup>16</sup> The Bosnia and Herzegovina Accounting and Auditing ROSC (World Bank 2004) provides a more detailed analysis.



**Who must be audited?** All JSCs are required to have an external auditor (FBiH LE §44,246&248; RS LE §57,61&64), and in practice most JSCs do produce audited financial statements. Under the LPE in each entity, SOEs must have an external auditor and are subject to audit and oversight by the public sector Supreme Audit Authority.

**Compliance with ISA.** Outdated translations of International Standards of Audit (ISA) are used as audit standards in both entities. The FAA will require the use of ISA for all companies with revenue of one million KM or greater or 50 or more employees. The 2004 LPE in each entity also calls for SOEs to comply with ISA.

**Auditor independence.** In FBiH auditors cannot audit companies in which they have invested. If an audit company provides other services to a client, the service must be performed by another division of the company. Requirements in RS are similar. In practice, BiH auditors do provide additional services, such as consulting, through separate departments.

**Audit committee.** As noted below, many companies in BiH have “audit boards”. No companies in BiH have audit committees made up exclusively of supervisory or management board members, though an individual board member may have responsibility for disclosure or a related area.

**Competent and Qualified Audit Enforcement.** The institutions responsible for ensuring audit quality in both entities failed to provide quality assurance that was independent of auditors and audit firms, and overall audit quality is perceived as low<sup>17</sup>. The FAA provides for new oversight regime under the ISC and the Ministry of Finance.

**Auditor qualifications.** The accounting law in each entity set requirements for accountants and auditors in terms of education and work experience, and required professional examinations administered by local institutions. In practice, while auditor education has improved, and the big four are represented by correspondent firms, most auditors are sole proprietors who will be challenged to meet ISA or review IFRS compliant statements. The FAA gives the newly created ISC responsibility for setting qualifications, examinations, and requirements for continuing professional education.

**Audit boards and other oversight bodies.** All JSCs in FBiH, as well as banks and SOEs in each entity, are required to have an audit board. In FBiH the audit board is elected by shareholders. Members of this board do not serve on the supervisory board, and are legally distinct from the external auditor. Audit boards have limited oversight powers, and can audit the company at the request of shareholders with 10% or more ownership. Under the LPE, SOE audit boards are also elected by shareholders, and cannot be members of the supervisory or management boards. They have some additional powers beyond FBiH audit boards, including the oversight of an Internal Audit Department.

Supervisory boards in RS also play an oversight role that in practice is similar to the audit board in FBiH companies.

**Principle VD: External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.**

**Assessment: Partially Observed**

**Requirements for oversight of audit.** In FBiH the GMS shall “make decisions on the... reports of the auditor [and] selection of an outside auditor” (FBiH LE §246). In the RS the GMS elects and replaces the auditor, determines compensation and sets procedures for their work (RS LE §61). The right of the GMS to choose the auditor seems to be observed in practice, though normally this implies that the largest shareholder chooses the auditor. In SOEs, the LPE in each entity empowers the Audit Board to choose and oversee the external auditor.

**Auditor accountability.** In each entity, the legislation on auditor liability is vague and has never been tested. Auditors face a range of sanctions, but these have not been imposed. In the FBiH, while auditors have civil liability under the law and relevant regulations, the law does not specify whether the liability extends to third parties (e.g. creditors or shareholders) and lawyers contend that third parties would be in a difficult position to prove before a court that they have the legal title and standing to pursue a claim for damages against an auditor. In the RS, lawyers are more confident regarding auditor third party liability, but a statutory cap on auditor liabilities limits its effectiveness<sup>18</sup>.

**Auditor insurance.** Auditors in each entity have an obligation to take out liability insurance. The details of these policies are not in the public domain and their implications for effective auditor liability or compensation for aggrieved parties unclear.

**Principle VE: Channels for disseminating information should provide for equal, timely and cost-efficient access to relevant information by users.**

**Assessment: Partially Observed**

Basic company documents can be inspected at the JSC’s local court register and copied for a fee. Full financial statements are available for a fee from specialized agencies--FIPA in FBiH, AFIP in RS--that are the descendants of the old central payment system. Shareholders can request information directly from the JSC at their own expense.

**Material facts.** LS and SC regulations in each entity require JSCs to report on major transactions and other significant

<sup>17</sup> *ibid*

<sup>18</sup> *ibid*

events to both the SC and to the public through publication in a daily newspaper. The report should include a short description of the event, time and place of the event, and a list of participating legal entities and physical persons. The stock exchanges can also request (the few) listed companies to provide certain information.

**Published information (papers, web).** Annual statements including summary financial information and some other required reports are published in daily newspapers. The Sarajevo Stock Exchange website includes the financial reports of PIFs. The Banja Luka Stock Exchange Website has semiannual financial statements and data on ownership structure for JSCs. A “webportal” is planned in the RS that will include annual and semiannual statements, the top ten owners of each company, and other data.

**Principle VF: The corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice.**

**Assessment: Partially observed**

Brokers in each entity trade on their own account while working with retail clients and performing certain investment banking services. They are regulated and licensed by their respective SC. Investment advisors must also be licensed in each entity, currently only a few licensed advisors are operating in FBiH, none in RS. Securities are not currently rated, however the credit bureau has expressed interest in developing ratings. Both SCs are active in enforcing relevant regulations.

**Disclosure of conflicts of interest by analysts, brokers, rating agencies, etc.** The RS LS requires intermediaries to place the interest of the client above their own and prohibits providing or spreading false information (§37,38). The FBiH LS requires that brokers report conflicts of interest to clients and prohibits the disclosure of incomplete or inaccurate information (§87,123).

## SECTION VI: THE RESPONSIBILITIES OF THE BOARD

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

**Principle VIA: Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.**

**Assessment: Materially not observed**

**Basic description of board.** JSCs in BiH have a variety of board requirements. In the FBiH, JSCs have a supervisory board, which appoints the director who in turn appoints executives with the board's approval. Management does not serve on the supervisory board, but in practice, the director and other executives attend board meetings.

In the RS, joint stock companies have a supervisory board and a management board, and an optional committee of executives. Both boards are elected by shareholders, weakening the supervisory board's authority over management. The management board is a mixed board composed of both representatives of shareholders and management. In this regard, the management board in the RS is similar to a traditional one-tier board—but one that is supplemented by the oversight / supervision of the supervisory board.

SOEs in each entity have a distinct two-tier board structure, with a supervisory board that appoints the management board. Banks in each entity have a single supervisory board, as in FBiH.

The following tables summarize the board structures:

	FBiH Joint Stock Companies	RS Joint Stock Companies	Public Companies (in each entity)	Banks (in each entity)
Supervisory board?	Yes. Management cannot be supervisory board member.	Yes. Not mandatory in companies with less than 100 employees. (LE §65)	Yes	Yes
Appointed by...	Shareholder meeting	Shareholder meeting	Shareholder meeting	Shareholder meeting
Management Board?	No corporate management board. CEO is called the “Director” and presides over management.	Yes. Not mandatory in companies with less than 100 employees. (LE, §65)	Yes	No
Appointed by...	Supervisory board	Shareholder meeting	Supervisory board	Supervisory board
Audit Board	Yes	No	Yes	Yes
Board size requirements	SB must have odd number of members, minimum 3. (LBC, §259)	Minimum three each board.	Minimum three on the supervisory board.	Chairman plus at least four members (maximum 7 total, must be an odd number).

Term Limits	The supervisory board chairman and members are appointed simultaneously, for a four year term of office.	Cannot exceed five years.	As other companies in the entity.	The supervisory board chairman and members in case of bank are appointed simultaneously for a four years term.
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**Nomination and election.** In FBiH the supervisory and audit board are elected by shareholders in the GMS. Shareholders with 5% or more voting shares may propose nominees (FBiH LE §261). Law requires the use of cumulative voting, but this is not always used in practice. In RS, members of the management and supervisory board are elected by shareholders in the GMS. There are no special rules for nomination by minority shareholders, though company statutes and practice may allow for a minority representative on the board. As noted under IIA5, SOEs have distinct rules for choosing members of the supervisory and management board.

**Eligibility requirements.** Members of the management / management board and their family members cannot sit on the supervisory board in either entity (FBiH LE § 263; RSLE §67). Someone convicted for an “economic” crime or abuse of position cannot be a supervisory board member in either entity, or management board member in the RS (FBiH LE § 259; RS LE§66). Foreigners and non-shareholders can be appointed to the board in both entities. Foreigners on the board are considered employees and must obtain the relevant visas. Company statutes may provide for conditions regarding qualifications and other requirements for appointment of management board members.

For banks, the banking agencies in each entity must approve the appointment of supervisory board members, and at least half the board must be judged to have the relevant knowledge and experience. Politicians and civil servants cannot be bank supervisory board members. In the RS, supervisory board members must have a university degree and experience in the business for which the bank is licensed.

**Adequacy of duties of loyalty and care.** In general, the “fiduciary-type” duties of supervisory board members are not clearly specified in the law.

In the *FBiH*, supervisory board chairman and members are required to carry out their commitments and responsibilities in accordance with the interests of the shareholders and the company, and may not perform activity that would compete with the activities of the company without the advice and consent of the other members of the supervisory board.” (FBiH LE §270). Similar language applies to banks in both entities (FBiH Law on Amendments to the Law on Banks, Article 31k-n, RS Law on Amendments to Banks, Article 64). The supervisory board chairman and members are “liable for damages caused by failure to comply or irregular compliance with their duties” and in some other specified areas (FBiH LE §272,273).

The voluntary Code issued by the FBiH SC provides additional guidance on duties, and notes: “members of the Supervisory Board are the servants of the shareholders and are required to act diligently in the best interests of the company. The members must execute their duties with loyalty to the company and with due care and attention”. However these standards are not enforced.

In RS “Members of the managing board and the board of executive directors perform their duties in the interest of a stock company and in doing so they act as good businessmen” (RS LE §264). Members of the management and supervisory board are liable to the company for all damages incurred due to their deliberate actions or negligence. The supervisory board members can also be liable for damages incurred due to a management board decision, if they knew or must have known of such decision and they did not inform the shareholders meeting. Only shareholders in RS can file suits against board members. The new voluntary Code provides additional guidance on board member duties.

The LPE in each entity require members of each board, as well as other company employees, to “carry out their duties with die care, compliance, and diligence”.

Lawsuits against directors are rare to non-existent.

**Insurance for directors.** There is no practice of providing insurance for board members.

**Principle VIB: Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.**

**Assessment: Partially observed**

There are no specific rules that require that boards treat all shareholders fairly when board decisions may affect different shareholder groups differently. Boards do not have legal obligations to any stakeholders other than shareholders. In practice, according to market participants, most boards continue to act in the interest of the controlling shareholders that appoint them.

**Principle VIC: The board should apply high ethical standards. It should take into account the interests of stakeholders.**

**Assessment: Partially Observed**

Codes of business ethics are not mandated for private sector JSCs in either entity. Companies must operate in accordance with the law, legal regulations and good business practice. The Law does not provide for any specific obligations for the company regarding anti-bribery and corruption. The new voluntary RS Code encourages that companies to take into

consideration the interest of stakeholders, particularly employees.

Business Chamber of Sarajevo Canton recently promoted the first business ethics code that specifies the goals and principles of business. Application is mandatory for members of the Chamber.

SOEs are required to have a code of ethics that is drawn up by the supervisory board based on guidance in the law and implemented by the management board. The supervisory and management boards in SOEs are to “endeavor” to insure lawful ethical behavior and oversee the company’s internal controls.

**Principle VID: The board should fulfill certain key functions, including:**

**Assessment: Partially observed**

(1) Board oversight of general corporate strategy and major decisions	<p><b>Board functionality by law, in practice, as recommended by Code.</b> In general, the management (or management board) is responsible for all management functions and day-to-day activities of the company, except for authorizations explicitly granted to the general meeting of shareholders and the supervisory board. The supervisory board in FBiH appoints and supervises management. In RS the management board and supervisory board are both elected directly by shareholders. The new Code in each entity provides additional guidance on the relative powers of board members and management.</p> <p><b>Director training, IOD.</b> There are no institutionalized director training programs in Bosnia and Herzegovina</p>
(2) Monitoring effectiveness of company governance practices	<p>There is no systematic oversight of company governance practices, and no practice of board evaluation or self-evaluation. The laws in both entities do not explicitly provide for any regular mandatory surveillance by the supervisory board over management operations, or any provisions for formally influencing management decisions (other than the power to appoint and dismiss management in the FBiH). The law allows the company to regulate such rights in the company articles of association.</p> <p>This role appears to be played to some extent by the company secretary in the FBiH. Supervisory boards appoint the secretary on the recommendation of the director. The secretary is responsible for shareholder recordkeeping, the conduct of shareholder meeting and supervisory board meetings and the preparation and maintenance of the minutes, and the safekeeping of all legally stipulated documents and company articles of association, except financial statements (LBC, Art 281 and 282). The secretary reports to the director, not to the board. Banks in the RS (but not other joint stock companies) have the same requirements.</p>
(3) Selecting / compensating / monitoring / replacing key executives	<p>In the FBiH and in banks in both entities, the supervisory board appoints the “director”. However, in the RS, the two boards are separately elected and removed by shareholders, with the management board choosing the director and other executives, thus greatly weakening the supervisory board.</p>
(4) Aligning executive and board pay with long term company and shareholder interests	<p><b>Supervisory Board</b></p> <p>In the FBiH, the SM decides on supervisory board member remuneration (LBC §276-277). In the RS, the law states that board remuneration “may be provided in proportion to their tasks and financial situation of the stockholding company”, or as provided in the articles of association or by the shareholders meeting. Supervisory board remuneration varies across companies, but tends to be minimal or symbolic.</p> <p><b>Management</b></p> <p>In the FBiH, remuneration of management is determined by the supervisory board, which concludes an agreement with the director. The compensation of other (executive) directors is determined by an agreement between the director and the executive director with the prior consent of the supervisory board. (LBC, §276-277)</p> <p>In the RS, management board remuneration is set by the shareholders meeting “in accordance with the tasks of the management board members and the financial situation of the stockholding company.” (LE, §266)</p> <p>In banks in both entities, the position, competences, liabilities and rights of the director are stipulated by an agreement between the supervisory board and the director. The salary and other material rights of executive directors are provided by an agreement between the director and the executive director, with previous consent of the supervisory board. (Law on Amendments to the Law on Banks, Article 32, Law on Banks of RS, Article 69 and 70).</p>
(5) Transparent board nomination / election process	<p>There are no rules governing the role of the board(s) in the nomination process.</p>

(6) Oversight of insider conflicts of interest, including misuse of company assets and abuse in RPTs	<p>In the FBiH, as noted in Principle IIIC, the supervisory board must disclose to the supervisory board any direct or indirect interest in the legal entity with which the joint stock company intends to establish a business relation (LBC, §270). The voluntary Code goes further and require that “the Supervisory Board, to the extent consistent with the law, shall implement in its own proceedings and establish for the management of the company” the duty of board members and management to act in the interest of the company, including the “principles of “recusal”, “disclosure of conflicts of interest”, and “transparency of compensation”.</p> <p>In the RS, the role of the supervisory board is similar; board member and management conflicts of interest must be disclosed.</p> <p>The voluntary Code in each entity provides additional guidance on the management of conflicts of interest.</p> <p>In SOEs, supervisory and management board members have a duty to promote responsible use of the company’s assets, implement the Code of Ethics (which prohibits conflicts of interest), and ensure the company complies with relevant laws on public procurement.</p>			
(7) Oversight of accounting and financial reporting systems, including independent audit and control systems		<b>FBiH JSC</b>	<b>RS JSC</b>	<b>Banks</b>
	Management	Submits a business report, as part of semiannual and annual account to the supervisory board. (LBC, § 269)	Prepares annual accounting statements and reports on transactions and implementation of business policy.	Same as FBiH.
	Supervisory board	Adopts the management business report, and submits annual business report to the SM. together with mandatory auditor’s report, report on work of supervisory board and auditing board, and business plan for the following business year. (LBC, § 269)	Examines interim and annual financial statements, determines legal compliance, reports on the annual accounting statements and operating reports enterprise which are to be submitted to the SM, and gives their opinion on profit distribution proposals. (LE, §64)	Same as FBiH.
(8) Overseeing disclosure and communications processes	Each voluntary Code notes that the board should oversee disclosure and ensure the integrity of company reporting.			
<b>Principle VIE: The board should be able to exercise objective independent judgment on corporate affairs.</b>				
<b>Assessment: Partially Observed</b>				
(1) Director independence	<p><b>Director independence in law and in Code.</b> There are no independence requirements in the law or regulation. Supervisory boards in each entity do not include (and are in theory independent from) management. The new voluntary RS Code does call for a majority of the supervisory board to be independent from management, not be former members of the management board, and free of other potential conflicts of interest.</p> <p>In SOEs in each entity, civil servants and politicians may not serve on any board, and party officials may not serve on the management board.</p> <p><b>Director independence in practice.</b> Board independence is a new concept in BIH and has not yet been put in practice. In many companies with minority shareholders, minority shareholders are allowed in practice to nominate / appoint one representative on the board. However, this minority representation is designed to support the interests of minorities, not to represent the interests of all shareholders of minority shareholders.</p>			
(2) Clear and transparent rules on board committees	<p><b>Audit committees.</b> Audit committees are not used in BiH. Companies are required to establish “auditing boards” (see Principle VC above). However, these committees are elected by shareholders and are not true board committees.</p> <p><b>Other committees.</b> With the exception of the committee of executive directors in RS,</p>			

	board committees are not generally used, although companies and especially banks do set up temporary committees for special purposes.
(3) Board commitment to responsibilities	<p><b>Restrictions on the number of board seats.</b> In the FBiH, the same person may not be supervisory board chairman or member in more than three companies (LBC, §264) or banks (Law on Amendments to the Law on Banks, §31f). In the RS, there are no limits on the number of board seats, although the board member is required to disclose his other board memberships (LE, §70). In banks, the number of bank board seats is limited to three (Law on Banks, §59). In practice, some market participants report a few instances of individuals sitting on a large number of boards.</p> <p><b>Board meeting requirements.</b> In the FBiH, the supervisory board must meet every three months (LBC, §266); in banks, it must meet once per month (Law on Amendments to the Law on Banks, §31). In the RS, there are no specific requirements; bank supervisory boards must meet every three months (Law on Banks, §60).</p> <p><b>Public availability of board attendance.</b> Board attendance is recorded in the minutes (CL, §360). Board minutes are available to shareholders at the company (CL, §319).</p>
<b>Principle VIF: In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information.</b>	
<b>Assessment: Partially observed</b>	
In the <i>FBiH</i> , the chairman and members of supervisory board have the right to request all the data on business operations (FBiH LE, §274). In both entities, the supervisory board has the power to receive to review and receive all relevant information. There are no legal provisions that govern the power of supervisory board members to engage professional advisors.	

# Bosnia and Herzegovina Terms/Acronyms

**Acquis Communautaire:** The body of legislation of the European Communities and the European Union. Applicant countries must accept the *acquis* before they can join the EU.

**BiH:** Bosnia and Herzegovina

**BLSE:** Banja Luka Stock Exchange

**CEO:** Chief executive officer

**CRS:** Central Registry of Securities

**Cumulative voting:** Cumulative voting allows minority shareholders to cast all their votes for one candidate. Suppose that a publicly traded company has two shareholders, one holding 80 percent of the votes and another with 20 percent. Five directors need to be elected. Without a cumulative voting rule, each shareholder must vote separately for each director. The majority shareholder will get all five seats, as s/he will always outvote the minority shareholder by 80:20. Cumulative voting would allow the minority shareholder to cast all his/her votes (five times 20 percent) for one board member, thereby allowing his/her chosen candidate to win that seat.

**EU:** European Union

**FBiH:** The Federation of Bosnia and Herzegovina. One of two entities in Bosnia and Herzegovina.

**GMS:** General meeting of shareholders

**GDP:** Gross Domestic Product

**IFRS:** International Financial Reporting Standards

**ISA:** International Standards on Auditing

**ISC:** Independent Standards Commission. A state level body that will oversee accounting and auditing.

**JSC:** Joint Stock Company

**KM:** Convertible Mark

**LE:** Law on Enterprises

**LPE:** Law on Public Enterprises

**LS:** Law on Securities

**PIF:** Privatization Investment Fund

**Pre-emptive rights:** Pre-emptive rights give existing shareholders a chance to purchase shares of a new issue before it is offered to others. These rights protect shareholders from dilution of value and control when new shares are issued.

**Proportional representation:** Proportional representation gives shareholders with a certain fixed percentage of shares the right to appoint a board member.

**Pyramid Structures:** Pyramid structures are structures of holdings and sub holdings by which ownership and control are built up in layers. They enable certain shareholders to maintain control through multiple layers of ownership, while at the same time they share the investment and the risk with other shareholders at each intermediate ownership tier.

**RPT:** Related party transactions. The OECD Principles of Corporate Governance hold that it is important for the market to know whether a company is being operated with due regard to the interests of all its investors. It is therefore vital for the company to fully disclose material related party transactions to the market, including whether they have occurred at arms-length and on normal market terms. Related parties can include entities that control or are under common control with the company, and significant shareholders, such as relatives and key managers.

**RS:** The Republic Srpska. One of two entities in Bosnia and Herzegovina.

**SASE:** Sarajevo Stock Exchange

**SC:** Securities Commission

**Shareholder agreement:** An agreement between shareholders on the administration of the company, shareholder agreements typically cover rights of first refusal and other restrictions on share transfers, approval of related-party transactions, and director nominations.

**SOE:** State owned enterprise. In BiH this includes enterprises with significant entity or cantonal ownership.

**Squeeze-out right:** The squeeze-out right (sometimes called a "freeze-out") is the right of a majority shareholder in a company to compel the minority shareholders to sell their shares to him. The sell-out right is the mirror image of the squeeze-out right: a minority shareholder may compel the majority shareholder to purchase his shares.

**Withdrawal rights:** Withdrawal rights (referred to in some jurisdictions as the "oppressed minority," "appraisal" or "buy-out" remedy) give shareholders the right to have the company buy their shares upon the occurrence of certain fundamental changes in the company.

This report is one in a series of corporate governance country assessments carried out under the Reports on the Observance of Standards and Codes (ROSC) program. The corporate governance ROSC assessments examine the legal and regulatory framework, enforcement activities, and private sector business practices and compliance, and benchmark the practices and compliance of listed firms against the OECD Principles of Corporate Governance.

The assessments:

- use a consistent methodology for assessing national corporate governance practices
- provide a benchmark by which countries can evaluate themselves and gauge progress in corporate governance reforms
- strengthen the ownership of reform in the assessed countries by promoting productive interaction among issuers, investors, regulators and public decision makers
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